United States Postal Service
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Quarterly Financial Report

For the Three and Nine months Ended June 30, 2005

August 09, 2005

Part I. Financial Information

Part II. Other Information

Part I. Financial Information

Item 1. Financial Statements

United States Postal Service
Statements of Operations
(dollars in millions)

	Three months ended June 30, 2005 (unaudited)	Three months ended June 30, 2004 (unaudited)
Operating revenue	**$ 16,847**	$ 16,591
Operating expenses:		
Compensation and benefits	**13,410**	12,942
Transportation	**1,338**	1,229
Other	**2,274**	2,117
Total operating expenses	**17,022**	16,288
Income (Loss) from operations	**(175)**	303
Interest and investment income	**28**	7
Interest expense	**(93)**	(51)
Net Income (Loss)	**$ (240)**	$ 259

See accompanying notes to financial statements.

Item 1. Financial Statements

United States Postal Service
Statements of Operations
(dollars in millions)

	Nine months ended June 30, 2005 (unaudited)	Nine months ended June 30, 2004 (unaudited)
Operating revenue	**$ 52,929**	$ 52,091
Operating expenses:		
Compensation and benefits	**40,505**	39,147
Transportation	**4,055**	3,682
Other	**6,507**	6,407
Total operating expenses	**51,067**	49,236
Income from operations	**1,862**	2,855
Interest and investment income	**58**	23
Interest expense	**(203)**	(62)
Net Income	**$ 1,717**	$ 2,816

See accompanying notes to financial statements.

United States Postal Service
Balance Sheets – Assets
(dollars in millions)

	June 30, 2005 (unaudited)	September 30, 2004
Assets		
Current assets:		
Cash and cash equivalents	**$ 3,004**	$ 877
Receivables:		
Foreign countries	**666**	621
U.S. government	**251**	327
Other	**170**	187
Receivables before allowances	**1,087**	1,135
Less allowances	**112**	111
Total receivables, net	**975**	1,024
Supplies, advances and prepayments	**155**	220
Total current assets	**4,134**	2,121
Other assets, principally revenue forgone appropriations receivable	**361**	361
Property and equipment, at cost:		
Buildings	**20,344**	20,171
Equipment	**18,221**	17,277
Land	**2,806**	2,810
Leasehold Improvements	**1,138**	1,103
	42,509	41,361
Less allowances for depreciation and amortization	**22,035**	20,656
	20,474	20,705
Construction in progress	**2,008**	1,792
Total property and equipment, net	**22,482**	22,497
Total Assets	**$ 26,977**	$ 24,979

See accompanying notes to financial statements.

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

	June 30, 2005 (unaudited)	September 30, 2004
Liabilities and Net Capital		
Current liabilities:		
Compensation and benefits	**$ 3,786**	$ 2,640
Estimated prepaid postage	**1,258**	1,256
Payables and accrued expenses:		
Commercial vendors and accrued expenses	**1,105**	1,739
Foreign countries	**799**	778
U.S. Government	**54**	87
Total payables and accrued expenses	**1,958**	2,604
Customer deposit accounts	**1,649**	1,606
Outstanding postal money orders	**765**	767
Prepaid box rent and other deferred revenue	**405**	397
Debt	**-**	1,800
Total current liabilities	**9,821**	11,070
Non-current liabilities:		
Workers' compensation	**7,502**	6,651
Employees' accumulated leave	**2,141**	2,006
Other	**1,865**	1,321
Total non-current liabilities	**11,508**	9,978
Total Liabilities	**21,329**	21,048
Net capital:		
Capital contributions of the U.S. government	**3,034**	3,034
Retained earnings since reorganization	**2,614**	897
Total Net Capital	**5,648**	3,931
Total Liabilities and Net Capital	**$ 26,977**	$ 24,979

See accompanying notes to financial statements.

United States Postal Service
Statement of Changes in Net Capital
Nine months ended June 30, 2005 and the year ended Sept. 30, 2004
(dollars in millions)

	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital
Balance, Sept. 30, 2003	$ 3,034	$ (2,168)	$ 866
Net Income	-	3,065	3,065
Balance, Sept. 30, 2004	3,034	897	3,931
Net Income–Nine months ended June 30, 2005 (unaudited)	-	1,717	1,717
Balance, June 30, 2005 (unaudited)	**$ 3,034**	**$ 2,614**	**$ 5,648**

See accompanying notes to financial statements.

United States Postal Service
Statements of Cash flows
(dollars in millions)

	Nine months ended June 30, 2005 (unaudited)	Nine months ended June 30, 2004 (unaudited)
Cash flows from operating activities:		
Net Income	**$ 1,717**	$ 2,816
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	**1,543**	1,633
Loss on disposals of property and equipment, net	**2**	27
Increase in USPS workers' compensation liability	**851**	1,118
Increase in employees' accumulated leave	**135**	195
Increase in other liabilities	**544**	242
Changes in current assets and liabilities:		
Decrease in receivables, net	**49**	207
Decrease in supplies, advances and prepayments	**65**	18
Increase in compensation and benefits	**1,146**	1,318
Increase in estimated prepaid postage	**2**	-
(Decrease) in payables and accrued expenses	**(646)**	(937)
Increase (decrease) in customers deposit accounts	**43**	(17)
(Decrease) increase in outstanding postal money orders	**(2)**	15
Increase in prepaid box rent and other deferred revenue	**8**	10
Net cash provided by operating activities	**5,457**	6,645
Cash flows from investing activities:		
Purchase of property and equipment	**(1,554)**	(1,116)
Proceeds from sale of property and equipment	**24**	11
Net cash used in investing activities	**(1,530)**	(1,105)
Cash flows from financing activities:		
Issuance of debt	**-**	-
Payments on debt	**(1,800)**	(7,273)
Net cash used in financing activities	**(1,800)**	(7,273)
Net increase (decrease) in cash and cash equivalents	**2,127**	(1,733)
Cash and cash equivalents at beginning of year	**877**	2,266
Cash and cash equivalents at end of period	**$ 3,004**	$ 533
Supplemental Data		
Cash paid during the year for Interest	**$ -**	$ 19

See accompanying notes to financial statements.

Notes to Financial Statements

Note 1. Basis of Presentation

This interim report reflects the operations of the United States Postal Service for the three and nine months ended June 30, 2005 and June 30, 2004. 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 2004 Annual Report. 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. The Civil Service Retirement System (CSRS) "supplemental liability" represents an additional substantial estimate that, pursuant to Public Law 108-18 (P.L.108-18), is calculated by the Office of Personnel Management (OPM). The actual results experienced may differ from estimates.

In the opinion of management, the accompanying unaudited financial statements present fairly our financial position as of June 30, 2005, the results of our operations for the three and nine months ended June 30, 2005, and our cash flows for the nine months ended June 30, 2005.

Note 2. Retirement Programs

We account for our involvement in the retirement programs of the U.S. government as participation in a multiemployer plan arrangement in accordance with Financial Accounting Standard ("FAS") 87, *Employers' Accounting for Pension Costs*. Therefore, the costs of these benefits are expensed as we incur them. We provide pension benefits as defined by OPM and have a parent-subsidiary type relationship with the United States government. As a subsidiary we cannot direct the costs, benefits or funding requirements of the federally-sponsored plans.

Beginning October 1, 2004, the employer contribution for the Federal Employees Retirement System (FERS) changed from 10.7 percent to 11.2 percent. This had the impact of increasing retirement expense by approximately $28 million dollars for the quarter and approximately $83 million year-to-date.

We are required by P.L.108-18 to pay an additional annual amount, if necessary, each September, beginning in 2004, as determined by OPM. The additional amount is based on a calculation of any potential "supplemental liability", if one exists. 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. P.L. 108-18 requires that this supplemental liability be retired by September 30, 2043. In June OPM estimated the total supplemental liability to be $4,200 million as of September 30, 2004. The September 30, 2003 liability was $3,500 million. We were informed by OPM that our payment for September, 2005 is $290 million. The September 2004 payment was $240 million.

Note 3. Retiree Health Benefits

We are required to pay a portion of the health insurance premiums of those retirees and their survivors who participate in the Federal Employees Health Benefits Program (FEHBP). We account for our involvement in FEHBP as participation in a multiemployer plan arrangement in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Therefore, the costs of these benefits are expensed as we incur them.

Note 4. Emergency Preparedness Funding

Congress provided an appropriation of $587 million in 2002, to assist in paying for the decontamination of two of our facilities, and the purchase of equipment to enhance the safety of the mail, and protect our customers and employees. This appropriation has been fully expended. In December, 2004, an additional appropriation by Congress of $503 million provided funds for Ventilation Filtration Systems, Biohazard Detection Systems and an irradiation facility. These funds have not yet been expended. For both appropriations, revenue is recognized as the capital equipment purchased with the appropriation is depreciated. For the 3rd Quarter we recorded $11 million of depreciation expense and associated appropriations revenue. Year-to-date depreciation expense and associated appropriations revenue totaled $26 million. This brings the total revenue recognized from the 2002 appropriation to $313 million. Other costs of mail security and employee protection such as maintenance and consumable supplies are being funded from Postal revenue and charged as operating expense.

Note 5. Commitments
The following section summarizes our commitments for capital purchases and our lease obligations.

Capital
At June 30, 2005, our financial commitment (resources on order) for approved capital projects in process is $2,375 million.

Rents
At June 30, 2005 our future minimum lease payments for all non-cancelable leases are as follows:

Future Minimum Lease Payments		
($ in millions)	June 30, 2005	
Year	**Operating**	**Capital**
2005	**$ 238**	**$ 18**
2006	**830**	**74**
2007	**810**	**74**
2008	**771**	**74**
2009	**715**	**74**
After 2009	**6,249**	**572**
	$ 9,613	**886**
Less: Interest		**219**
Total Capital Lease Obligations		**667**
Less: Short-term Portion of Capital Lease Obligations		**10**
Long-term Portion of Capital Lease Obligations		**$ 657**

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 “Buildings” on the Balance Sheet. Capitalized leases were $838 million at June 30, 2005 and $847 million at September 30, 2004. Total accumulated amortization related to capital leases was $286 million at June 30, 2005 and $259 million at September 30, 2004. Amortization expense for capital lease assets is recorded as depreciation expense.

Note 6. 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, claims for property damages and suits and claims arising from postal contracts. Additionally we evaluate the materiality of cases determined to have a reasonable chance of adverse outcome. Such cases are immaterial to our financial statements. 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.

Item 2. Management's discussion and analysis of results of operations and financial condition

Cautionary Statements

The "Management's Discussion and Analysis of Results of Operations and Financial Condition" 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, 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 2004 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

Under the terms of the Postal Reorganization Act, the Postal Service (we) commenced operations on July 1, 1971 as an independent establishment of the executive branch of the United States government. The Act requires that the Postal Service offer mailing services as 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, 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 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 as well as through our website, USPS.com. Mail is delivered to over 143 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.

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.

Segmentation of marketing and product management, and generation of revenues, however, is oriented towards product lines. Our business segment reporting addresses volume growth and revenue generation by class of mail. As with the reporting on expenses, this mode of reporting on volume and revenues presents the results of and outlook concerning our operations as viewed through the eyes of management. We do not report revenues from individual customers since no single customer represents more than ten percent of our revenues.

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, we consult 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.

We are not subject to regulation by the Securities and Exchange Commission (SEC). However, we comply voluntarily with SEC financial reporting requirements to the extent that they reasonably may be applied 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, Use of Proceeds and Issuer Purchases of Equity Securities; Item 3 - Defaults upon Senior Securities; and Item 4 - Submission of Matters to a Vote of Security Holders.

Additional information on our organization and our finances, including our Cost and Revenue Analysis reports, Integrated Financial Plan, and Revenue, Pieces, and Weight reports, may be found in the “About USPS and News” section of our website, at www.usps.com.

Results of Operations

Operating revenue in the third quarter was $16,847 million, compared to $16,591 million in the corresponding quarter last year. Volume increased for all mail classes while revenue increased for all mail classes, except for First-Class and Periodicals. Overall for the quarter, mail volume increased by 2.4 percent or 1,192 million pieces.

Operating revenue year-to-date, was $52,929 million compared to $52,091 million reported for the same period last year. The increase of $838 million was primarily due to additional pieces of Standard Mail and First-Class workshared mail (workshared mail is mail for which the customer performs some preparation such as sorting and transportation that we would otherwise perform). The gain in First-Class workshared mail was essentially offset by a decline in First-Class single piece letters.

For the quarter, operating expenses grew by 4.5 percent. Compensation and benefits expense, driven by wage and benefit increases and growth in work hours, contributed to most of the increase over the same quarter last year. Supplies and services increased significantly due to purchases of cartridges for bio-detection systems, a planned increase in advertising spending, and higher purchases of mail transportation equipment. Transportation expenses, driven by significantly higher jet fuel, diesel, and gasoline prices, as well as increased mail volume contributed to the remaining expense growth.

The combined effect of these factors is a net loss of $240 million for the three months ending June 30, compared to a net income of $259 million in the same quarter last year. This quarterly loss was expected, given the seasonal nature of the mailing industry and the inflationary pressures on our costs cited above. Year-to-date net income of $1,717 million is $1,099 million less than the same period last year.

Summary of Interim Financial Results

Three months ended June 30,			Financial Results	Nine months ended June 30,		
2005	2004	%	($ in millions)	2005	2004	%
$ 16,847	$ 16,591	1.5%	Operating revenue	$ 52,929	$ 52,091	1.6%
			Operating expense			
13,410	12,942	3.6%	Compensation and benefits	40,505	39,147	3.5%
1,338	1,229	8.8%	Transportation	4,055	3,682	10.1%
603	553	9.0%	Supplies and Services	1,725	1,682	2.6%
527	534	-1.3%	Depreciation and amortization*	1,545	1,660	-6.9%
1,144	1,030	11.1%	Other Expenses	3,237	3,065	5.6%
17,022	16,288	4.5%	Total operating expense	51,067	49,236	3.7%
(175)	303	NM	Income (Loss) from operations	1,862	2,855	NM
28	7	NM	Interest and investment income	58	23	NM
-93	-51	NM	Interest expense	-203	-62	NM
$ (240)	$ 259	NM	Net Income (Loss)	$ 1,717	$ 2,816	NM

Note: Percentages are calculated based on un-rounded numbers.

NM: Not Meaningful to present as % difference.

* Depreciation and amortization as shown includes losses on disposals.

Operating Revenue

Operating revenue for Quarter 3 of $16,847 million was $256 million or 1.5 percent higher than for the same period last year. On a year-to-date basis operating revenue of $52,929 million was up $838 million or 1.6 percent over the same period last year. This occurred primarily due to the third quarter, 2005 having one more revenue day compared to the same period last year. The extra revenue day was worth approximately $250 million and accounts for the increase in revenue when compared to the same period in the prior year. Year-to-date, 2005 contains 1.5 additional revenue days when compared to 2004 accounting for approximately $350 million of the $838 million increase discussed above. After strong volume growth of 5.5 percent in Quarter 1, volume growth slowed considerably in Quarter 2 to 1.2 percent. In Quarter 3, volume grew by 1.2 billion pieces or 2.4 percent. Cumulatively, year-to-date volume growth now stands at 3.1 percent. Detailed volume and revenue data by product are shown in the tables on pages 14 and 15 respectively.

The majority of the volume growth in Quarter 3 came from Standard Mail which showed a 4.6 percent increase of just under 1,100 million pieces. On a year-to-date basis, total Standard Mail volume has increased 6.1 percent. Another highlight of Quarter 3 volume growth was a surge in volume in the package classes, Priority Mail, Express Mail and Package Services. Collectively the package classes' volumes grew by 7.5 percent in Quarter 3 when compared to the corresponding quarter last year. Package volume growth was also strong economy-wide during the quarter.

Total First-Class Mail volume grew 0.2 percent in Quarter 3. Third quarter increases in workshare First-Class letters volume (3.3 percent) and in First-Class Cards volume (8.0 percent) were almost completely offset by further erosion of First-Class single piece letter volume. Single piece First-Class letter volume decreased 4.0 percent in the third quarter.

Year-to-date, total First-Class volume growth is 0.4 percent, with growth occurring in workshare letters (4.4 percent) and cards (2.9 percent). Single piece First-Class letter volume continues its long, consistent decline, falling 4.0 percent for the first nine months of the year. In contrast, workshare letter volume has experienced four consecutive quarters of growth. We believe this contrast occurs because the negative effects of electronic diversion on single piece letters outweigh the positive effects of other factors such as employment and household growth, however this does not seem to be the case for workshare letters.

For both the third quarter and the year, Standard Mail volume exceeded First-Class Mail volume. This change in the mix of mail reflects the persistent, gradual erosion of single piece letter volume at a time when advertising by mail continues to maintain its share of a growing advertising market.

Priority Mail finished Quarter 3 with 7.5 percent volume growth. This is the fourth consecutive quarter of volume gains for Priority Mail. On a year-to-date basis, Priority Mail volume grew 4.1 percent or nearly 27 million pieces. Four factors underlie this performance. First, Priority Mail rates have stayed steady for almost three years while competitors' published rates have increased annually. Second, the proliferation of competitors' surcharges for fuel, residential delivery, and delivery in rural areas make Priority Mail increasingly attractive, especially for small-volume users of Priority Mail, who generally cannot negotiate discounts or other pricing concessions with private sector competitors. Third, Priority Mail is easier to use than ever. Customers can purchase postage and print mailing labels with free delivery confirmation on-line through Click-N-Ship (http://www.usps.com/onlinepostage) or on websites such as eBay. Carrier pickup saves customers a trip to the Post Office and, the flat rate envelope and flat rate box simplify Priority Mail use further. Finally, we have worked to consistently improve Priority Mail service performance.

Express Mail experienced positive growth of 4.0 percent in Quarter 3. This is the third straight quarter of volume gains for Express Mail. On a year-to-date basis Express Mail volume has grown 2.0 percent. Like Priority Mail, Express Mail has benefited from continued rate stability, and the impact of surcharges imposed by private sector competitors.

After beginning the year with strong growth in the first quarter (9.3 percent), Standard Mail volume growth has been positive, but below expectations. Standard Mail volume grew 4.6 percent in the third quarter. This followed growth of 4.1 percent in the second quarter. Year-to-date, Standard Mail has grown 6.1 percent. Mail continues to hold its ground in the advertising market by virtue of its two dominant characteristics: targetability and measurability. The lower than expected growth in Standard Mail volume coincides with slower than expected growth in total advertising spending, which has caused advertising forecasters to revise downward their estimates of 2005 spending.

Periodicals Mail volume grew 0.2 percent in Quarter 3 and 0.1 percent for the first nine months of the year. These growth rates were in line with expectations. However, weight per piece and revenue per piece were also lower for the quarter and year-to-date, suggesting weakness in the advertising market.

Package Services volume increased 7.7 percent in Quarter 3 on the strength of solid growth in Bound Printed Matter and Parcel Post. Bound Printed Matter volume, which grew 12.5 percent, historically exhibits somewhat erratic swings from quarter to quarter, so its Quarter 3 performance is not seen as an indicator of future volume growth. Parcel Post volume grew 5.8 percent. As with Priority Mail and Express Mail, Parcel Post is benefiting from the impact of competitors' surcharges and rate increases. Media Mail volume fell 0.2 percent while Library Mail volume declined 9.4 percent. On a year-to-date basis, Package Services grew 2.8 percent.

International Mail volume, which includes mail originating in the United States, increased 2.3 percent in Quarter 3. Year-to-date, International Mail volume grew 0.7 percent. Revenue from International Mail is growing faster for both Quarter 3 and year-to-date as volume shifted from Economy Mail classes to Air Mail classes.

"Other" volume, in the table below, includes Postal Penalty Mail (mail sent by the U.S. Postal Service itself), Free Mail for the Blind and Handicapped, and Mailgrams. Volume from Other mail grew 16.4 percent in the third quarter.

Volume by Class of Mail

Three months ended June 30			Volume	Nine months ended June 30		
2005	2004	% change	(millions of pieces)	2005	2004	% change
23,631.4	23,573.1	0.2	First-Class Mail	74,716.2	74,432.6	0.4
217.6	202.5	7.5	Priority Mail	676.1	649.5	4.1
14.4	13.8	4.0	Express Mail	41.7	40.9	2.0
2,285.3	2,281.2	0.2	Periodical Mail	6,915.9	6,906.6	0.1
24,129.4	23,064.2	4.6	Standard Mail	75,411.2	71,102.9	6.1
265.3	246.2	7.7	Package Services	868.3	844.4	2.8
205.6	200.9	2.3	International	655.7	651.4	0.7
173.2	148.8	16.4	Other	538.8	439.0	22.7
50,922.2	49,730.7	2.4	Total Mail Volume	159,823.9	155,067.3	3.1

Note: Percentages are calculated based on unrounded numbers.

Given constant postage rates over the last few years, changes in revenue performance are expected to be highly correlated with changes in mail volume. Differences in revenue and volume growth rates are attributable to mail mix changes within the categories reported herein. Specifically, if volume growth in a particular mail class exceeds revenue growth, this indicates that low yield (in terms of revenue per piece) volume within the class was growing faster than high yield volume. Put differently, when volume growth exceeds revenue growth, revenue per piece declines.

Since high yield single piece First-Class Mail volume fell while relatively low yield workshare volume rose, First-Class Mail revenue per piece declined. As a result, despite the modest growth of First-Class Mail volume, First-Class Mail revenue has declined, both for the third quarter and for the year-to-date. Similarly, within Standard Mail, growth is positive for lower yield categories such as ECR, Regular Automated, and Nonprofit, and negative for non-automated presort mail. This depresses the revenue growth relative to the volume growth. Finally, because the volume of lower revenue per piece Standard Mail has been growing faster than the volume of higher revenue per piece First-Class Mail, total revenues of the Postal Service have grown more slowly than total volume.

Revenue from Other mail increased 3.5 percent in Quarter 3 and 6.8 percent for the year-to-date. Much of this growth occurred in Special Services, which are enhancements to regular mail service, predominantly Certified and Delivery Receipt services as well as Money Order fees. Corresponding Special Services volumes do not exist. Also, Postal Penalty Mail generates no revenue since it is mail originated by the Postal Service itself.

Revenue by Class of Mail

Three months ended June 30			Revenue	Nine months ended June 30		
2005	2004	% change	($ millions)	2005	2004	% change
$ 8,684	$ 8,752	-0.8	First-Class Mail	$ 27,491	$ 27,696	-0.7
1,118	1,032	8.3	Priority Mail	3,541	3,399	4.2
224	216	3.8	Express Mail	657	646	1.8
539	547	-1.3	Periodical Mail	1,643	1,654	-0.6
4,521	4,360	3.7	Standard Mail	14,173	13,498	5.0
492	479	2.7	Package Services	1,688	1.686	0.1
438	403	8.7	International	1,369	1,296	5.6
831	802	3.5	Other	2,367	2,216	6.8
$ 16,847	$ 16,591	1.5	Total Operating Revenue	$ 52,929	$ 52,091	1.6

Note: Percentages are calculated based on unrounded numbers.

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

Operating Expenses

Compensation and Benefits and Workhour Analysis

Total compensation and benefits for Quarter 3 were $13,410 million, or 3.6 percent higher than the prior year period amount of $12,942 million. This increase of $468 million was driven by salary and benefit increases of $527 million, which included an increase in wages of $222 million, retirement contributions of $90 million, $71 million in employee health benefits and an increase in workhour usage that added the equivalent of $144 million. Retiree health benefit increases of $56 million were offset by other personnel cost decreases of $1 million and a $114 million decrease in workers compensation costs. Year-to-date total compensation and benefits costs are $40,505 million, 3.5 percent or $1,358 million higher than same period last year. This increase was driven by salary and benefits increases of $1,453 million. Included in this amount, were wages of $892 million, retirement contributions of $176 million, $239 million for employee health benefits and an increase in workhour usage added the equivalent of $146 million. Retiree health benefit increases of $130 million and other personnel cost increases of $33 million were offset by a $258 million decrease in workers compensation costs.

In comparing this year's Quarter 3 performance to the previous year, it should be noted that the National Day of Mourning (NDM) on June 11, 2004 in honor of former President Reagan lowered the number of workhours used during Quarter 3 of 2004, as it was a paid holiday for the Federal Government, including the United States Postal Service. This reduced 2.2 million hours in delivery functions, 0.6 million hours in distribution functions, and 0.4 million hours in all other (including administrative) functions. The effect of the NDM on expense comparisons between the two periods is minimal.

Wages
Wages grew in Quarter 3 by $222 million and year-to-date, by $892 million compared to same period last year. This is due to increases in wage rates, workhour usage, and a minimal increase in overtime usage. Bargaining unit employees received pay increases of 1.3 percent in November 2004, along with annualized cost of living increases of $624 per eligible employee in September, 2004 and $208 in March, 2005. National Association of Letter Carrier employees received an annualized cost of living increase of $229 per eligible employee in March, 2005. Included in the wages growth is the impact of a 0.1 percent growth in overtime hours in Quarter 3 and 12.5 percent year-to-date. This contributed $22 million in Quarter 3 and $478 million year-to-date to the total wage increases.

Our cost of providing health benefits to current employees increased by $71 million or 5.8 percent, from the same quarter last year. Year-to-date, our cost of providing employee health benefits have increased by $239 million or 4.9 percent.

Other Personnel Compensation
Workers' Compensation costs represented approximately 2.0 percent of compensation and benefits expenses in Quarter 3 and 2.2 percent year-to-date. Our employees are covered by the Federal Employees' Compensation Act, administered by the Department of Labor's 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 cost per claim. Data from OWCP show that for the current chargeback year (July 1, 2004 through June 30, 2005), paid Medical claims are down 4.1 percent, while the average cost for these claims rose 3.3 percent. For compensation claims, the number of paid claims is down 4.6 percent with the average cost per claim increasing by 2.9 percent. Total cash outlays by the OWCP for these claims have declined by $13 million for the current chargeback year ending June 30, 2005, as compared to the prior year. Our expenses are subject to adjustment based on claims information provided by OWCP. In the third quarter we had $258 million in workers' compensation expense, which is $114 million less than last year's third quarter expense. Year-to-date we had $858 million in workers' compensation expense, which is $258 million less than last year's expense.

Retiree Health Benefits costs were about 2.9 percent of compensation and benefits expense in Quarter 3. 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. The major drivers of Retiree Health Benefits expense are the number of participants on the rolls and premium costs of the plans they select. As of June 30, 2005, we had approximately 442,000 participants on the rolls, an increase of about 8,900 over the prior year. Our expense related to retiree health benefits was $387 million during this quarter, compared to $331 million in the third quarter of 2004. Year-to-date expense was $1,122 million compared to $992 million in 2004.

Workhours and salaries and benefits by Function for Quarter 3 of 2005 compared with the same period last year. Functional definitions can be found in Item 6.

Workhours Three months ended June 30,				Salary & Benefits Three months ended June 30,		
(Thousands)				($ Millions)		
2005	2004	%		2005	2004	%
			Operations:			
2,531	2,274	11.3%	-Operations Support	$ 112	$ 97	14.7%
81,482	80,930	0.7%	-Mail Processing	2,814	2,747	2.4%
46,080	42,996	7.2%	-Rural Delivery	1,320	1,196	10.3%
117,722	115,157	2.2%	-City Delivery	4,173	4,005	4.2%
7,974	7,913	0.8%	-Vehicles Services	300	289	3.8%
20,371	20,149	1.1%	-Plant & Equip Maintenance	760	727	4.6%
58,002	57,442	1.0%	-Customer Services, Retail & Sales	2,003	1,939	3.3%
30,664	29,214	5.0%	Postmasters & Installation Heads, Administration, and Other	1,235	1,190	3.9%
364,826	356,075	2.5%	Total	12,717	12,190	4.3%
				Other Personnel Compensation		
			Workers' Compensation	258	372	-30.7%
			Retiree Health Benefits	387	331	17.2%
			Other	48	49	-5.4%
364,826	56,075	2.5%	Total	$ 13,410	$ 12,942	3.6%

Note: Percentages are calculated based on unrounded numbers.

Quarter 3 Workhours

A change in workhours 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 possible deliveries. In our third quarter, mail volume increased by 1,190 million pieces, or 2.4 percent, and we added 2.0 million new possible deliveries, as compared to the same quarter last year. This workload increase would, without productivity improvement, require the equivalent of 3.3 million additional workhours. There was a total increase of 8.8 million workhours, or 2.5 percent, from the comparable period last year.

Total deliveries have grown to a rate of 2.0 million deliveries per year, resulting in a combined rural delivery and city delivery increase of 5.6 million workhours over the same quarter last year. The workload impact of this increase in the delivery network is equivalent to 2.1 million workhours.

Workhours and salaries and benefits by Function year-to-date 2005 are compared with the same period last year. Functional definitions can be found in Item 6.

Workhours Nine months ended June 30, (Thousands)				Salaries & Benefits Nine months ended June 30, ($ Millions)		
2005	2004	%		2005	2004	%
			Operations:			
7,179	6,780	5.9%	-Operations Support	$ 316	$ 286	10.3%
255,033	256,052	-0.4%	-Mail Processing	8,679	8,494	2.2%
133,641	127,621	4.7%	-Rural Delivery	3,815	3,523	8.3%
353,791	348,448	1.5%	-City Delivery	12,554	11,989	4.7%
24,024	24,084	-0.2%	-Vehicles Services	898	867	3.6%
60,913	61,239	-0.5%	-Plant & Equip Maintenance	2,262	2,178	3.9%
176,494	175,622	0.5%	-Customer Services, Retail & Sales	6,062	5,854	3.6%
90,591	92,949	-2.5%	Postmasters & Installation Heads, Administration, and Other	3,743	3,685	1.6%
1,101,666	1,092,795	0.8%	Total	38,329	36,876	3.9%
				Other Personnel Compensation		
			Workers' Compensation	858	1,116	-23.5%
			Retiree Health Benefits	1,122	992	13.2%
			Other	196	163	19.6%
1,101,666	1,092,795	0.8%	Total	$ 40,505	$ 39,147	3.5%

Note: Percentages are calculated based on unrounded numbers.

Year-to-Date Workhours

Year-to-date, mail volume increased by 4,760 million pieces, or 3.1 percent, as compared to the same period last year. This workload increase would, without productivity improvement, require the equivalent of 9.4 million additional workhours. Continued cost control kept workhour usage to an increase of 8.9 million workhours over the comparable period last year, even after accounting for the 3.2 million workhour increase over last year due to the National Day of Mourning (details included in the Compensation and Benefits and Workhour Analysis section). As stated previously, total deliveries have grown to a rate of about 2.0 million deliveries per year, resulting in a workload impact in the delivery network of 3.6 million hours over the first nine months of last year.

Employee Complement

Employee complement increased in Quarter 3. Although the number of career employees, not including the Office of the Inspector General (OIG), increased 1,141 during the quarter, the number of career employees has been reduced 3,743 since the end of last year. We expect the annual complement reduction for 2005 will likely be less than recent years. At the end of Quarter 3 career complement, not including the Office of Inspector General, is 702,960.

Retirement Expense

With certain exceptions, our employees participate in one of three retirement programs based on their date of employment. These programs are the Civil Service Retirement System (CSRS), the Dual CSRS/Social Security System, and the Federal Employees Retirement System (FERS). Each of these programs is described in further detail in note 6 to the financial statements included in our 2004 Annual Report. The programs are administered by the Office of Personnel Management (OPM). The expenses of all of our retirement programs are included in compensation and benefits expense.

The Postal Civil Service Retirement System Funding Reform Act of 2003, Public Law (P.L. 108-18), changed the way we fund our Civil Service Retirement System obligations and altered the related schedules for our payments to the CSRS. P.L.108-18 was enacted in response to a November 2002 review of estimates and our payments into and returns earned by the CSRS. OPM determined that at our then current rate of funding, we would pay substantially more than would be needed to cover the future benefits expected to be paid to our employees and retirees participating in CSRS. The history and impact of P.L.108-18 is discussed in the "Retirement Expense" and the "Public Law 108-18 and Proposed Legislation" sections of our 2004 Annual Report.

The implementation of P.L.108-18 in May 2003 did not alter the fact that retirement expenses remain a significant portion of our total expenses. Retirement contributions for current employees, which are included in compensation and benefits expense, represented 10.4 percent of our total expenses during the third quarter. They increased by $776 million (inclusive of the FERS contribution rate change of $28 million) compared to Quarter 3 of 2004, when these benefits represented 10.1 percent of total expenses. Year-to-date retirement expenses, representing 10.3 percent of our total expenses increased by $1,972 million (inclusive of the FERS contribution rate change of $83 million) compared to 2004, when these benefits represented 10.3 percent of total expenses as well.

Transportation

Transportation expenses were $1,338 million, an increase of $108 million, or 8.8 percent, for the quarter. Year-to-date expenses were $4,055 million, an increase of $373 million, or 10.1 percent. Transportation costs are largely made up of air and highway transportation. Rail and other transportation costs make up the remainder of this category.

Air transportation expenses were $605 million, an increase of $57 million, or 10.4 percent, over the same quarter last year. This is primarily attributed to increased fuel charges as well as increased mail volume and contractual rate increases for our dedicated air transporter. During the third quarter, the index by which the jet fuel costs are calculated for our dedicated air carrier increased 56.3 percent from the same quarter last year. This resulted in an increase in fuel costs for the dedicated air transportation of approximately $23 million for the quarter. Increased volume added an additional $9 million in fuel costs. Air transportation mail volume for the dedicated fleet is measured in millions of cubic feet (MCF). Mail volume increased by 4.7 MCF over the same quarter last year and added $25 million dollars to the cost of air transportation. Our contract unit cost per cubic foot of delivery increased 3.75 percent over the prior year adding an additional $11 million. Finally, international air transportation and terminal handling services increased $10 million over the same period last year. These increases were offset by decreases in commercial air expenses of $25 million compared to 3rd quarter 2004.

Year-to-date air transportation expenses were $1,832 million, an increase of $222 million, or 13.8 percent compared to the prior year. This again is primarily attributed to increased fuel charges, increased mail volume and contractual rate increases for our dedicated air transporter. For the year, the jet fuel cost index increased 50.6 percent. This resulted in an increase in fuel costs for the dedicated air transportation of approximately $61 million. Increased volume added $20 million in fuel costs. Mail volume increased by 11.5 MCF year-to-date. These mail volume increases added $61 million dollars to the cost of air transportation. The contract per unit cost of delivery increase of 3.75 percent added $32 million year-to-date. Finally, international air transportation and terminal handling services increased $42 million over the same period last year.

Highway transportation expense of $649 million increased by $65 million, or 11.2 percent, over the same quarter last year. The increase was driven primarily by higher fuel prices, contractual rate increases for drivers as well as re-allocation of our shipping mix over the past year. During the third quarter, weekly retail gasoline prices increased an average of 31.7 percent from a year ago. This resulted in an increase in fuel costs for fleet operations of approximately $32 million for the third quarter We are contractually obligated under the Service Contract Act to adjust contract payments to drivers each year based on the Department of Labor wage determinations. These payment increases resulted in $19 million of additional costs in the 3rd quarter. In 2005 we shifted a majority of mail previously carried by rail transportation to highway. This shift resulted in an increase in highway transportation charges of $10 million dollars for the quarter.
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For the year highway transportation costs were $1,977 an increase of $171 or 9.5 percent over the same period last year. Fuel prices have increased by an average of 34.2 percent resulting in approximately $76 million in additional expense. Driver contractual increases added $56 million of additional costs year-to-date, while CPI clauses in the contracts added an additional $9 million. Transportation of Mail mix changes, shifting more mail to highway routes has increased highway costs $23 million dollars year-to-date.

Rail and other transportation expenses decreased $14 million dollars for Quarter 3 and $20 million year-to-date, again, due primarily to discontinued use of Amtrak mail delivery service.

Supplies and Services
Supplies and services expenses of $603 million were $50 million or 9.0 percent higher than last year's comparable quarter. Supplies expense increased $32 million over the same quarter last year. The purchase of consumable cartridges for the bio-detection systems (BDS) accounted for $15 million of this spending increase this quarter, a planned increase in advertising expenses accounted for $14 million and planned purchases of mail transportation equipment accounted for an additional $12 million increase in expenses compared to the prior year period. Offsetting these increases was a reduction in equipment rental & repairs of $8 million.

Year-to-date supplies and services expenses were $1,725 million, which is $43 million or 2.6 percent more than same period last year. Increased advertising spending of $52 million and $36 million of spending on BDS cartridges was offset by a reduction of $34 million in services expenses. In 2004 we spent $55 million to decontaminate the Trenton and Washington, DC facilities closed in the Anthrax attacks. Planned purchases of mail transportation equipment accounted for a $21 million increase in expenses compared to the prior year. Offsetting this increase was a reduction in equipment rental & repairs of $40 million.

Depreciation and Amortization
Depreciation expenses of $527 million were in line with last year's comparable quarter. Year-to-date depreciation expenses are $1,545 million which is $115 million or 6.9 percent less than same period last year. The depreciation decrease year-to-date is the result of consistent decreases in capital spending in prior years.

Other Expenses
Other expenses of $1,144 million were $114 million or 11.1 percent higher than last year's comparable quarter. The major components included in this category are rent and utilities of $378 million, vehicle maintenance services of $269 million, information technology of $104 million and communications of $58 million. Rent and utilities, up 1.2 percent, have experienced slower growth in Quarter 3. Vehicle maintenance services are increasing, up 14.7 percent, as the fleet ages and as fuel cost rise. Increases in information technology costs of $7 million or 7.8 percent were a reflection of new software maintenance and licensing agreements. Communications charges have increased primarily due to upgrades in telephone and networking services. Additionally, in Quarter 3, we increased our allowance for the probable adverse settlement of two labor-related arbitration cases. This contributed more than half of the increase in Other expenses in Quarter 3.

Year-to-date, we witnessed the same trend, as Other expenses of $3,237 million increased $172 million or 5.6 percent. Rent and utilities of $1,192 million was up 3.3 percent, vehicle maintenance services of $749 million increased 10.8 percent and communications of $168 million rose 4.3 percent compared to the same period last year. Information technology costs of $252 million were down 20 percent, a reflection of the continuing downward price trend in this industry and favorable negotiation on software maintenance and licensing agreements. The increased allowance for adverse arbitration settlements that occurred in Quarter 3 contributed significantly to this growth as well.

Interest Expense

Interest expense of $93 million was $42 million higher than last year's comparable quarter and year-to-date interest expense of $203 million was $141 million over the same period last year. Almost all of our interest expense is due to the CSRS supplemental retirement obligation. The supplemental payment amount due in September 2005, most of which is interest, of $290 million is $50 million higher than the 2004 amount. In addition the expense of the 2004 initial supplemental payment was recognized over the 17 months from the enactment of the law until the payment due date. The CSRS "supplemental liability" interest recognized was $92 million for Quarter 3, 2005 and $201 million year-to-date compared to $51 million for the 3rd quarter and year-to-date last year.

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 and special services and carrier services to an expanding delivery network. TFP calculations include inputs for all resources including labor, materials, transportation and capital investments.

Quarter 3 TFP related workload increased by 2.2 percent, with resource usage increasing 2.1 percent, yielding a 0.1 percent increase in TFP. TFP growth has been positive in twenty-three of the last twenty-four quarters. Quarter 3 workload was primarily driven by an increase in mail volume with transportation of military mail also having a significant impact. Resource usage increased this quarter and was driven by an increase in labor usage and a slight increase in capital. These increases along with an increase in material usage that was driven by increases mainly in air transportation were the contributing factors of the lower than usual TFP results for the Quarter.

The year-to-date TFP related workload increased by 2.1 percent, while resource usage increased by 0.7 percent, yielding a 1.4 percent increase in TFP. This productivity growth is equivalent to approximately $742 million in expense reductions year-to-date.

Financial Condition

Debt and Liquidity

As of June 30, 2005, we had no outstanding debt with the U. S. Treasury's Federal Financing Bank, as was the case for the same period last year. This represents a reduction of $1,800 million from year-end 2004. Cash and cash equivalents were $3,004 million, $2,127 million higher than September 30, 2004, and $2,471 million higher than at the end of June, 2004.

The first three quarters of our year typically produce strong cash flow. We used the net cash flow from our operating activities to eliminate our debt outstanding after providing for capital investment.

We do not anticipate any borrowing until the end of the year. In September, we will have approximately $1.2 billion in lump sum payments for workers' compensation and retirement obligations. 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 day's 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 day's notice.

Capital Expenditures and Commitments

The capital commitments year-to-date through the third quarter were $1,158 million compared to $1,078 million in 2004.

During the third quarter, the Board of Governors approved funding for four projects: Tractors and Spotters, Carrier Route Vehicles, Phase 2 of the Flat Recognition Improvement Program, and a modification to the Automated Package Processing System project. Commitments for the quarter were again driven primarily by the following Board approved projects:

- Integrated Dispatch and Receipt System - automates mail dispatch and receipt functions by deploying a site-specific combination of ten equipment systems at each facility.

- Emergency Preparedness Protection - permits completion of the purchase and installation of 1,705 Bio-hazard Detection System units in 282 mail processing facilities and support sites nationwide.

The capital cash outlays year-to-date were $1,554 million in 2005 compared with $1,116 million in 2004. The table below summarizes 2005 activity year-to-date compared to last year.

Capital Commitments, Expenditures, and Resources on Order

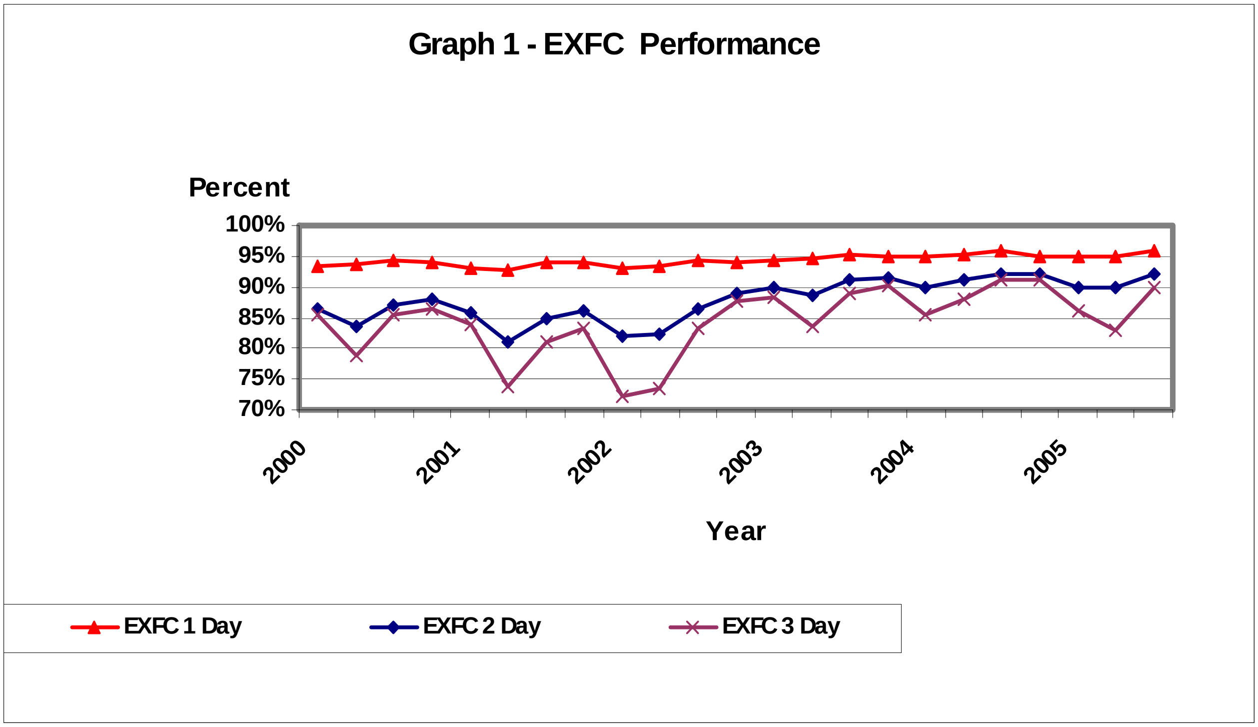
CAPITAL INVESTMENTS	COMMITMENTS		CASH OUTLAYS		RESOURCES ON ORDER	
($ millions)	Year-to-date Through June 30,		Year-to-date Through June 30,		June 30	September 30,
	2005	2004	2005	2004	2005	2004
CONSTRUCTION AND BUILDING PURCHASE	$ 152	$ 61	$ 163	$ 111	$ 178	$ 192
BUILDING IMPROVEMENTS	208	160	311	185	272	380
MAIL PROCESSING EQUIPMENT	243	596	514	506	1,305	1,601
VEHICLES	32	170	129	92	24	126
RETAIL EQUIPMENT	1	30	55	70	41	95
POSTAL SUPPORT EQUIPMENT	522	61	382	152	555	414
TOTAL	$ 1,158	$ 1,078	$ 1,554	$ 1,116	$ 2,375	$ 2,808

Service and Performance

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

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.



Graph 1 – EXFC Performance summarizes EXFC results by quarter since 2000. Even with the reductions in career employees and work hours, we have maintained a high level of service for all categories. For Quarter 3 all categories showed improvement from the prior quarter. This is typical as we move from the winter months and into spring and summer. This quarter is the sixth consecutive quarter for which we have achieved national EXFC 1 Day scores of 95 percent or above. EXFC 2 day results showed modest improvement from the prior quarter while remaining flat as compared to the same quarter last year. EXFC 3 day results have improved from the prior quarter but remained relatively flat when compared to the same quarter last year.

Customer Satisfaction

Independently measured customer satisfaction for residential household customers for Quarter 3 showed that 93 percent of these customers rated their experience with us as “excellent”, “very good” or “good.” We can now claim 15 continuous quarters at 93 percent or higher.

Rate and Classification Activity

The Postal Rate Commission is an independent establishment of the executive branch of the United States government. The Commission reviews our 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, to recommend decisions regarding rate complaints by interested parties, and to report 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.

On April 8, the Postal Service filed a request for an increase in rates and fees that would increase most rates and fees by 5.4 percent. Some exceptions have been proposed to ensure that rates or fees cover costs or to meet statutory requirements. The case is Postal Rate and Fee Changes Pursuant to Public Law 108-18, PRC Docket No. R2005-1. Revenues requested in this filing will fund the 2006, $3.1 billion Congressionally-mandated escrow requirement established by Public Law 108-18. Were it not for this escrow requirement, the Postal Service would not have filed this rate increase request.

On April 15, the Postal Rate Commission recommended a two-year experiment for Premium Forwarding Service. (Request of the United States Postal Service for a Recommended Decision on the Experimental Premium Forwarding Service, PRC Docket No. MC2005-1, filed November 19, 2004). This service provides customers with another option for receiving their mail while they are temporarily away from home. On May 10, the Governors approved the Commission's recommended decision and the Board set August 7 as the implementation date.

On June 20, the Postal Rate Commission recommended that the United States Postal Service enter into a three-year Negotiated Service Agreement with HSBC North America Holdings Inc. (HSBC), (PRC Docket No. MC2005-2). The HSBC Negotiated Service Agreement is based on the recently recommended Capital One Services, Inc. (Capital One) Negotiated Service Agreement and pertains to First-Class Mail. This agreement creates opportunities for the Postal Service to reduce costs and increase revenues by tailoring its mail services to the unique characteristics of its mailers.

One classification case remains open. On February 16, 2005, the Governors acted on the PRC's Recommended Decision on the Bank One Corporation NSA (PRC Docket No. MC2004-3). The Governors allowed the recommendations to take effect under protest, and returned the case to the PRC to allow reconsideration of whether a cap should limit the discounts available to Bank One under the NSA. The Governors also asked the PRC to clarify its views on what circumstances and evidence would justify not applying a cap to similar NSAs in the future. The PRC set a procedural schedule, but has not yet issued a further recommended decision.

There are four proposed rulemaking hearings in process. The first concerns defining the term "postal service"; 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; the third involves an expansion of the PRC's administrative procedures to require additional, detailed periodic reporting of financial and operational information; and the fourth is a solicitation of comments on the first use of the rules for functionally equivalent NSAs. Six complaint cases are also open concerning removal of collection boxes, the Electronic Postmark, cost-based rates for Periodicals Mail, alleged First-Class Mail service level changes, sale of stamped stationery, and alleged Express Mail service level changes. Specific information on these pending dockets can be obtained at the PRC web site http://www.prc.gov.

Outlook

The outlook for the remainder of 2005 remains positive, but is increasingly challenging. Expense growth accelerated somewhat due largely to further increases in fuel prices and COLAs for our bargaining employees. We expect these pressures to continue through the fourth quarter and into next year.

Our net income through the first nine months of the year was substantially better than we had planned entering the year. For the year, we planned for a $200 million net loss. We anticipate that we will post a modest net loss in the fourth quarter; however, we will achieve a net income for the year in excess of $1 billion.

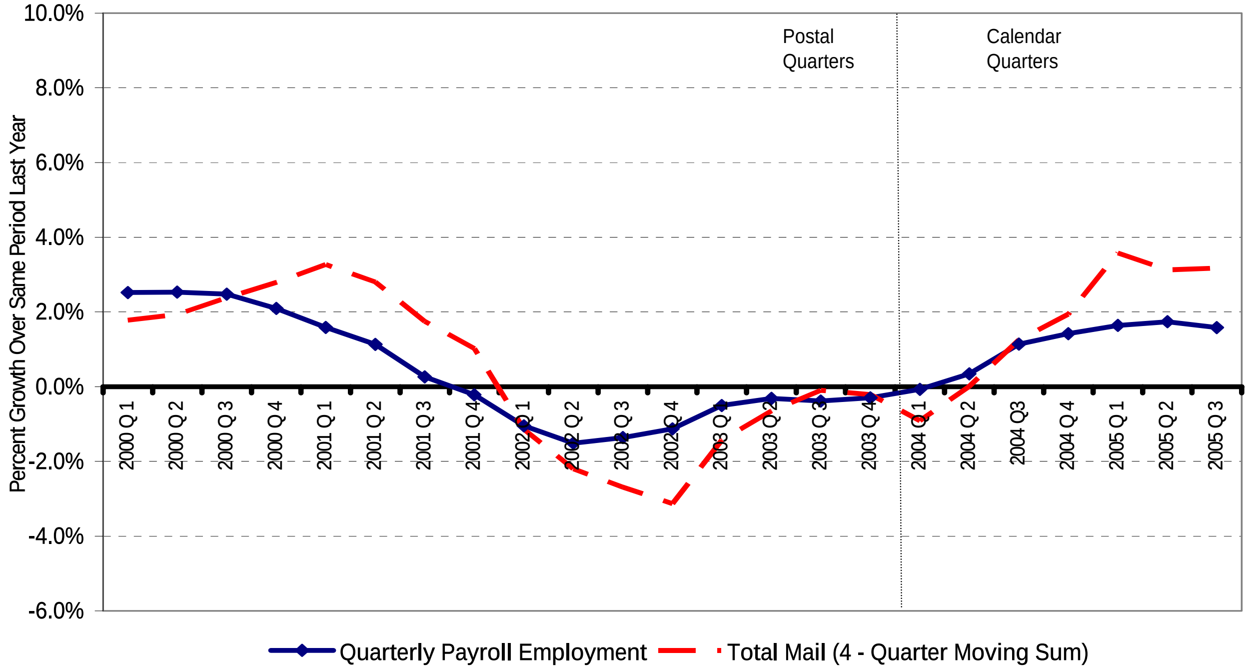
Revenue Outlook

The revenue outlook for the remainder of the year remains positive. Results from Quarter 3 show strength in Priority Mail, Express Mail and Package Services. These strengths are balanced by a somewhat weak performance in single-piece First-Class Mail.

Growth in economic activity was solid through most of 2004 and should continue through the remainder of 2005 and 2006. Macroeconomic forecasters lost some of their confidence when real Gross Domestic Product growth in Quarter 2 of 2005 was announced preliminarily at a somewhat disappointing 3.1 percent. This news was followed by reports of lackluster growth in other measures of economic activity such as retail sales and employment. Not surprisingly, economists began talking of a "soft patch" in economic growth. Subsequent revisions to the real Gross Domestic Product growth numbers raised the preliminary estimate twice, first to 3.65 percent and then to 3.8 percent. These revisions and subsequent good news about retail sales and employment have provided reassurance that the economy remains on a solid foundation and that steady positive economic growth is expected to continue through 2006.

Employment and Total Mail volume growth are compared in Graph 2 Total Mail Volume and Payroll Employment. As Graph 2 shows, mail volume losses (measured as four-quarter moving sums) tracked declines in payroll employment in 2002 and 2003. Then mail volume growth turned positive in 2004, coincident with employment growth. This continues into 2005. In fact, mail volume growth has exceeded employment growth for four consecutive quarters. Mail volume growth is expected to slow in the fourth quarter, because of seasonal patterns in business and because of a stronger than usual fourth quarter in 2004. Moreover, volume growth in 2006 will be suppressed by an expected 5.4 percent increase in rates at the start of Quarter 2.

Graph 2
Total Mail Volume and Payroll Employment

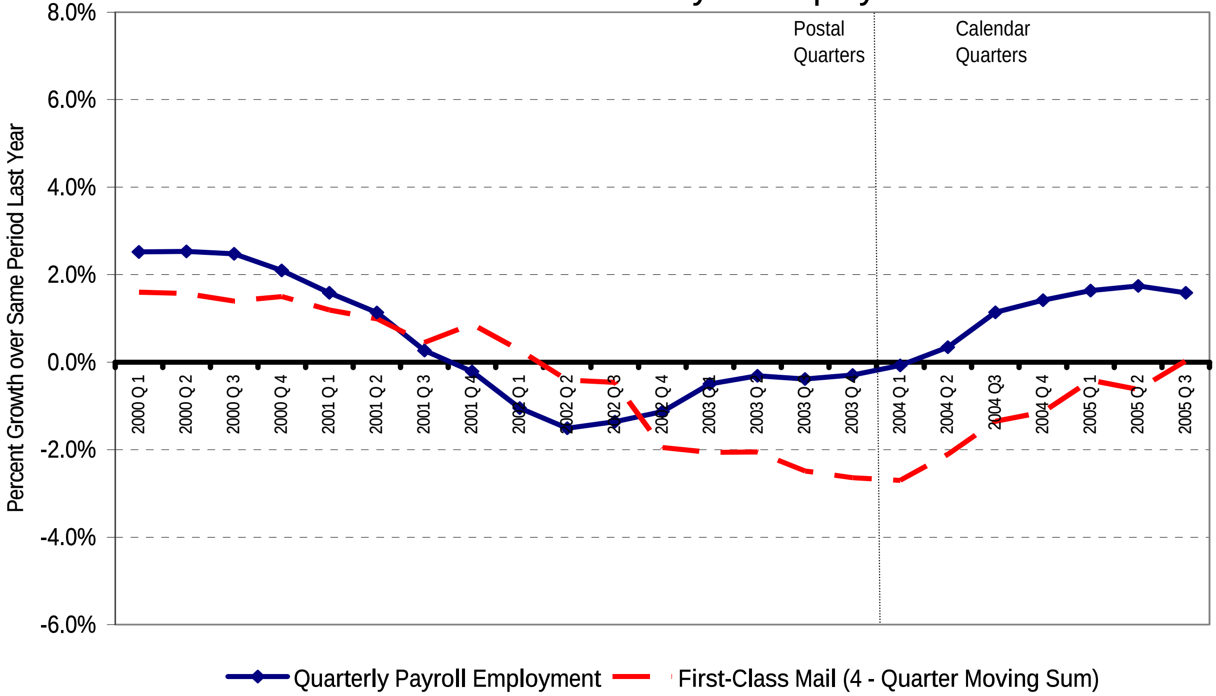


Continued employment growth will positively affect total mail volume, but will have a lesser affect on total revenue because of mail mix changes, which continue the substitution of low-revenue-per-piece volumes for high revenue-per-piece volumes.

First-Class Mail has been and continues to be affected by diversion and consolidation. Electronic diversion of hard copy communications like bill payments continues unabated, despite recent concerns about data security. An additional type of diversion occurs when mail consolidators, among the fastest growing postal customers, convert single piece mailings into bulk mailings. Consolidation of single piece First-Class Mail into workshare First-Class Mail is relatively innocuous financially since single piece and workshare letters generate similar per piece contribution. Consolidation becomes a concern to the extent single piece First-Class mail is converted to Standard Mail, which has a lower contribution per piece than First-Class.

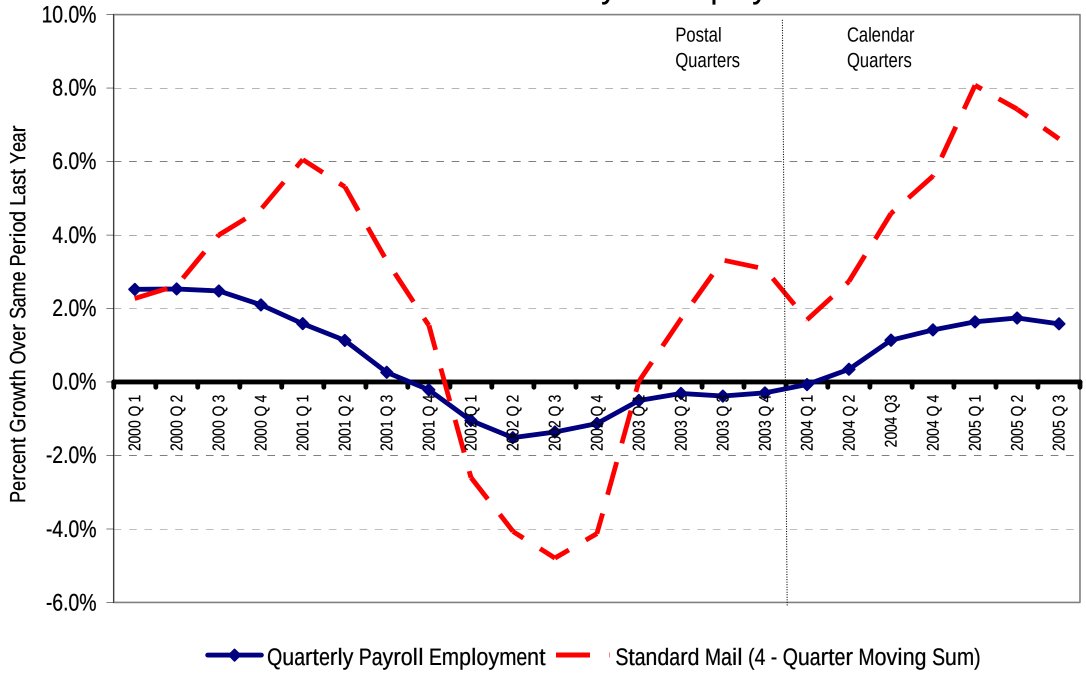
Graph 3 on page 26 graphs the trend in First-Class Mail volume growth (on a moving 4-quarter sum basis) in relation to payroll employment. First-Class Mail volume growth is consistently slower than growth in Payroll Employment for the last three years. Although the gap in growth rates is closing somewhat, the continued loss of single piece letter volume is expected to keep First-Class Mail growth below employment growth indefinitely.

Graph 3
First-Class Mail Volume and Payroll Employment



We project continued Standard Mail volume growth through the remainder of the year due to the positive economic outlook, and continuing strength in direct marketing channels. Projected softness in advertising expense growth for the remainder of the year is likely to attenuate Standard Mail growth. As Graph 4 Standard Mail Volume and Payroll Employment shows, Standard Mail is growing more rapidly than the payroll indicator, although the gap has narrowed somewhat over the last six months. Because Standard Mail is a favored marketing channel, volume and revenue should continue to grow more rapidly than payroll employment.

Graph 4
Standard Mail Volume and Payroll Employment



Priority Mail volume growth has now been positive for four consecutive quarters. This last occurred in 1999. Express Mail has grown for three consecutive quarters for the first time since early Quarter 1 of 2001. The strong showing of Priority Mail and Express Mail through the end of June is changing expectations of future performance for these products. Private sector competition, however, is at very high levels as our competitors continue to add service features and price aggressively.

Despite forecasts of steady economic growth, there are numerous indications of risks in the macroeconomic outlook. Energy prices have fluctuated over the last three months and recently reached new highs. In the longer term, energy price increases are expected to exceed the increase in overall prices because of increasing global demand, particularly from the fast growing economies of Asia. A speculative surge in housing prices has raised concerns that a recurrence of the stock market bubble and its aftermath may slow economic growth. The double deficits (international trade and federal government budget) also provide cause for concern. Finally, U.S. consumers continue to buy at unprecedented, and, some say, unsustainable levels, forgoing savings. In light of these concerns, it is somewhat surprising that talk of recession or stagnation is not more prevalent.

Expense Outlook
The outlook for the fourth quarter of 2005 is for an increase in the rate of expense growth to slightly above 4 percent. We expect moderate growth in volume and a continuation of steady growth in delivery points. Some of this workload will be absorbed through productivity improvements and the outlook for achieving our targeted program cost savings for the year remains good.

The continued high level of fuel costs remains a serious concern. In addition to transportation, increased energy costs for the year continue to negatively affect a variety of other non-personnel items, including utility expenses, vehicle servicing costs, rents and leases and rural carrier equipment maintenance allowances. The effects of fuel inflation also impact the consumer price index, upon which cost of living adjustments (COLAs) for our bargaining employees are based.

We expect total 2005 expenses to be slightly higher than our original plan but this will be more than offset by increases in revenue. We also expect that our productivity improvements for 2005 will be greater than planned, due to the absorption of the majority of the larger than expected volume increases.

Our preliminary outlook for 2006 is to offset projected increases in fuel costs, health benefits (particularly retiree health benefits), COLAs, and an increase in delivery points with an aggressive set of cost reduction programs, as we attempt to hold our expense increases close to the rate of expected inflation. These cost pressures would add approximately $3 billion in expenses in 2006 before accounting for these cost reduction programs. Our expected savings from capital investment programs, other productivity initiatives, and a reduction in Headquarters programs is expected to hold overall expense growth in 2006 to less than $2 billion.

Pending Legislation

On January 4th, 2005, Representative John McHugh introduced the Postal Accountability and Enhancement Act, H.R. 22, a bill to reform the postal laws of the United States. The House passed the Act on Tuesday, July 26, 2005 by a margin of 410 to 20. The full text of the proposed legislation can be found at the website http://thomas.loc.gov/.

On March 17th, 2005, Senator Susan Collins introduced the Postal Accountability and Enhancement Act, S.662, a bill to reform the postal laws of the United States. It has been placed on Senate Legislative Calendar under General Orders. Calendar No. 164. The full text of the proposed legislation can be found at the website http://thomas.loc.gov/.

Our Postmaster General/CEO, John E. Potter testified before Congress on April 26, 2005 concerning the legislation identified above and that testimony can be found at the usps.com website as listed under the press releases in Item 5.

In a press released dated August 2, 2005, the Board of Governors addressed a number of matters, among them the Postal reform legislation winding its way through Congress. The Governors reviewed how the Postal Service would operate in the event there were no reform legislation and determined that we would build on our recent progress in controlling costs and generating revenue. Under this scenario, the Governors anticipate a further rate increase for 2007 in mid-single digits and then target future annual increases at CPI or below.

The Governors also discussed the extreme difficulties the Postal Service would have meeting consumers' needs in the event new legislation were enacted that was revenue neutral and that at the same time gave the Board very limited authority to govern the organization as an efficient business enterprise.

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 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

We are in the process of 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. However, we are not working to comply as rapidly as is required for companies with publicly traded securities. We are using the Committee of Sponsoring Organizations of the Treadway Commission (COSO) control framework to document, test and report on our reporting controls. We are currently documenting and updating the controls over our financial processes. These processes are under review and existing documentation will be revised to conform to the COSO framework.

No material control deficiencies or weaknesses were identified or reported during the quarter ending June 30, 2005.

Part II. Other Information

Item 1. Legal proceedings

See Note 6, Contingent Liabilities, June 30, 2005 financial statements.

Item 5. Other information

Labor Agreements

Because our workforce is heavily unionized, our costs are largely determined by the provisions of existing labor agreements. Our current agreements call for regularly scheduled general wage increases and cost-of-living allowances (COLA). The COLA adjustments are calculated based on the "National Consumer Price Index for Urban Wage Earners and Clerical Workers" (CPI-W), published by the Bureau of Labor Statistics, using a conversion rate of 1 cent per hour for each full 0.4 of a point increase in the CPI-W index. COLA adjustments are made in March, based on the January CPI-W and September, based on the July index. In no event will a decline below the base index result in a decrease in the pay scales covered by our collective bargaining agreements.

Summaries of the relevant portions of our major agreements follow:

The current agreement with the American Postal Workers Union (APWU) results from the combination of an arbitration award in March 2001 and a subsequent 2-year contract extension that was ratified in March 2002. The 5-year agreement with the APWU is due to expire on November 20, 2005. During the last year of the agreement, 2005, APWU employees will receive regularly scheduled COLA payments in March and September. In November 2004, APWU employees received a 1.3 percent general increase, the last scheduled general increase under the current collective bargaining agreement. In June 2005 we reached a tentative one-year contract extension with the American Postal Workers Union (APWU, AFL-CIO). The agreement, if ratified by union members, will affect approximately 287,000 Postal employees represented by the APWU. The tentative contract extension covers the period from November 20, 2005 through November 20, 2006. The tentative agreement provides for a 1.6 percent wage increase effective March 18, 2006 and includes the continuation of the cost-of-living allowance.

The current agreement with the National Association of Letter Carriers (NALC) was negotiated and subsequently ratified in June 2002. The 5-year agreement with the NALC is due to expire on November 20, 2006. During 2005, NALC employees will receive regularly scheduled COLA payments in March and September. In addition, in November 2005, employees will receive a 1.3 percent general wage increase. During 2006, COLA payments will be paid in March and September.

National Postal Mail Handlers Union members ratified a two-year contract extension with the United States Postal Service in May 2003. This action results in a 1.3 percent wage increase for approximately 58,000 postal employees effective November 27, 2004, and a 1.3 percent increase effective November 26, 2005. Other terms of this contract extension, covering the period from November 20, 2004, through November 20, 2006, provide for the continuance of March and September COLA payments and the establishment of a joint task force to discuss issues relating to repositioning employees. All other terms of the contract remain the same.

In November 2004, the National Rural Letter Carriers Association (NRLCA) extended their collective bargaining agreement with us by two years. The existing collective bargaining agreement was originally set to expire on November 20, 2004. It has now been extended to November 20, 2006. The agreement provides for a 1.3 percent wage increase effective November 27, 2004, and a 1.3 percent increase effective November 26, 2005. Terms of the agreement include continuing the March and September COLA payments, establishing a standard time allowance for reloading and unloading vehicles, increasing the reimbursement rate for rural carriers who furnish their own vehicles and creating a joint task force to discuss issues related to future developments in mail delivery. All other provisions of the contract remain in effect.

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.

U.S. Postal Service And American Postal Workers Union
Reach Tentative Contract Extension Agreement
June 28, 2005 - News Release #05-057

Postmaster General Selects Postal Veterans As Key Officers
June 17, 2005 - News Release #05-054

Postal Service Invites Customer Comment About Future Direction
May 3, 2005 - News Release #05-037

Statement of John E. Potter, Postmaster General/CEO
Before House Subcommittee
April 26, 2005 - For Immediate Release

U.S. Postal Service Seeks Customized Postage Vendors
April 26, 2005 - News Release #05-034

Congressional Testimony of John E. Potter, Postmaster General/CEO
April 14, 2005 - For Immediate Release

Postal Service's COO Patrick Donahoe Becomes Deputy Postmaster General
April 12, 2005 - News Release #05-032

Escrow Rate Case Filed
April 8, 2005 - News Release #05-030

Item 6. Exhibits and reports

Functional Definitions

Operations Support consists of supervisory, administrative and clerical hours in support of mail processing, delivery and retail operations. Operations Support activities assist field operations in optimizing efficiency.

Mail Processing includes workhours for manual, mechanized and automated distribution of the mail.

Rural and City Delivery functions include delivery and collection of mail, carrier office and street activities, supervisory support, and training.

Vehicle Services includes hours for operating and maintaining the postal vehicle fleet and support hours for stockroom duties and vehicle accident investigations.

Plant and Equipment Maintenance includes hours for maintaining mail handling equipment, building maintenance and custodial activities.

Customer Services includes workhours in support of retail and delivery operations at post offices. This includes providing service to customers at window units, distribution of mail to post office boxes and to rural and city delivery routes, and miscellaneous clerical duties in support of retail and delivery services.

Postmasters and Installation Heads, Administration, and Other covers all remaining functions, including support activities involving information systems, finance, human resources, marketing and sales at all locations. This category also includes employees on limited duty and rehabilitation. In 2004, we began an effort to change in how we track workhours for employees in limited duty or rehabilitation assignments. The workhours for limited duty and rehabilitation employees are now included in their functional areas as we attempt to return these employees to full duty.