FY2003 SECOND QUARTER REPORT

November 30, 2002 to February 21, 2003

UNITED STATES POSTAL SERVICE

FINANCIAL CONDITION & RESULTS

RESULTS OF OPERATIONS QUARTER 2, FY 2003 COMPARED TO PLAN & QUARTER 2, FY 2002

For the quarter beginning November 30, 2002 and ending February 21, 2003, the Postal Service realized a net income of $645 million compared to a plan of $360 million. The $285 million favorable variance was due to the expense plan underrun of $559 million that more than offset a revenue plan underrun of $274 million.

OPERATING REVENUE AND MAIL VOLUME

In PQ 2, the Postal Service earned $16.4 billion in revenue on volume of 46.9 billion pieces of mail. Revenue grew 5.3% due to the impact of rate increases. Volume declined by 451,000 pieces, less than 0.1% compared to that same quarter last year. Revenue was $274 million or 1.6% below plan. Volume was 723 million pieces below plan.

The revenue and volume performance to plan had the largest negative impact in the higher margin products; First-Class Mail, Priority Mail and Express Mail. The volume performance compared to plan was less unfavorable for Standard Mail. The revenue and volume shortfalls reflect the impact of an economy growing less rapidly than had been assumed, the negative influence of continuing electronic diversion, the effect of competitor and ground service inroads on air parcel services (affecting Priority Mail and Express Mail), and severe winter weather.

First-Class Mail revenue of $9.2 billion was $186 million, or 2.0%, below plan. Higher rates from the June 30, 2002 increase produced a 5.2% increase in revenue even though First-Class volume declined by 1.6% (409 million pieces) compared to the same quarter last year. This decline, though smaller than the declines of the previous two quarters, reflects continued electronic diversion and economic weakness.

This is the sixth consecutive quarter of declines in First-Class Mail volumes. A source of particular concern is the drop in First-Class workshare mail volume. This was the third consecutive quarter of decline in workshare First-Class Mail which includes bills, statements and premium advertising messages.

Consistent with Quarter 1 results, Priority Mail volume fell 15.1% and revenues were 3.8% below the same quarter last year. Priority Mail volume and revenue were under plan by 8.7% and 7.8%, respectively. Express Mail volume and revenue were also below plan by 6.7% and 5.5%, respectively. Express Mail volume dropped 12.1% and revenue dropped 3.9% from the same quarter last year. These product lines were negatively affected by businesses moving packages to ground delivery services, the sluggish economy, and intense competition in the air and ground package delivery markets.

Standard Mail volume increased by 497 million pieces, or 2.7% over the same quarter last year. The rate of growth was less than Quarter 1 of this year, but this was expected because the same quarter last year had a stronger base. This is the third consecutive quarter of growth for Standard Mail. Year-to-date volume is still running below the levels of FY 2000 and FY 2001. The main determinant of future Standard Mail growth will be the economy and the recovery of the advertising market. Standard Mail revenue increased 9.8% compared to the same quarter last year, but was $24 million below plan.

Package Services revenue was $55 million over plan, or 10.3%, while Package Services volume was similarly over plan, at 22 million pieces, or 8.2%. Compared to the same quarter last year, Package Services volume increased by 18.5 million pieces or 6.9%. Within Package Services, Parcel Post volume was 5.6% above last year. Parcel Post volume also exceeded plan by 11 million pieces or 11.2%.

INTEREST INCOME

Interest income for the second quarter totaled $11.6 million compared to a plan of $6.9 million. For the year, investment income is $23.3 million versus a plan of $17.3 million. Higher than expected net income combined with lower than planned capital expenditures have increased cash flow resulting in higher than projected short-term investments returns.

OPERATING EXPENSE

Expense plan under runs were achieved in spite of the pressure on expenses created by winter weather that was more severe than normal in the Mid-Atlantic and Northeast regions of the country and, once again rising fuel costs.

Operating expense of $15.3 billion was $554 million or 3.5% below plan. Personnel compensation was $221 million under plan or 1.8%. Non-personnel expenses were $334 million below plan, or 9.5%.

Continued reductions of employees through attrition and reductions in work hours are responsible for savings in personnel compensation. In Quarter 2, work hours were reduced 0.7% greater than the planned 3.4% reduction utilizing 5,700 less career employees than Quarter I. Work hours for the period were 2.3 million under plan and 14.6 million below Quarter 2 of FY 2002.

Transportation expense for the quarter was $76 million, or 5.6% below plan due in part to the decrease in transportation requirements and tighter contract controls. Supplies and services expense was $138 million or 20.5% under plan for the quarter. Supply chain management activities have greatly assisted in the control of our supplies and services expenses.

Total expenses declined by $36 million, or 0.2%, from the same quarter last year and were $559 million under plan.

INTEREST EXPENSE

Interest expense for the second quarter totaled $461 million, which is $4 million below plan. Interest expense includes interest on deferred retirement liabilities ($371 million) and on borrowings ($90 million).

PRODUCTIVITY

Total Factor Productivity increased 4.3% in Quarter 2 compared to the same quarter last year. Workload declined 0.3% during the quarter in spite of 1.5% delivery workload growth compared to the same quarter last year. At the same time resource usage was reduced by 4.6% compared to a plan decrease of 0.7%. This is the largest quarterly reduction in resource use since quarterly data has been recorded. It marks the fifteenth quarter of reductions in resource usage. This has been accomplished through careful management of work hours and tight cost controls. Output per work hour was 3.2%.

CAPITAL COMMITMENTS AND EXPENDITURES

Capital commitments for Quarter 2 of $225 million were $112 million less than planned.

Commitments for the Flats Feeder Enhancement De-Stacking Retrofit program were $74 million, the Field Material Handling Systems program accounted for $22 million and the Biohazard Detection System accounted for $13 million during Quarter 2. The remaining $116 million was spread over all other capital programs.

Capital cash outlays of $315 million for the quarter were $154 million or 32% under forecast. All categories except mail processing equipment were under the forecast.

ASSETS

At the end of Quarter 2, total current assets increased by $536 million compared to the end of FY 2002. The increase was the result of a $469 million increase in cash. The Postal Service typically experiences strong positive cash flows during the early part of its fiscal year. When it is practical to do so, excess cash is applied toward debt reduction as discussed below. We used our positive cash flow to reduce debt outstanding by $3.6 billion from the balance at the end of the last fiscal year.

The net decline of $349 million in the property, plant, and equipment account represents the difference between the acquisition of additional assets and the depreciation of existing assets. Fixed assets increased $640 million, construction in progress decreased $268 million, leasehold improvements net of amortization increased $11 million, and depreciation increased $732 million.

Deferred retirement costs and the retirement liability increased $662 million as a result of the general pay increases of CSRS employees and cost-of-living-adjustments (COLAs) for retirees in the current fiscal year. The current portion of the deferred retirement costs are amortized to expense which reduces the balance of the intangible asset. (Further discussion of deferred retirement liabilities is included at the end of the document).

LIABILITIES

The current liabilities, excluding the current portion of debt, have increased $1.1 billion for the year. This increase is the result of increases in payables and accrued expenses.

Total debt has declined by $3.6 billion. Strong positive cash flows driven primarily by net income and moderate capital spending enabled this reduction. The current level of debt is not, however, a good measure for the level of debt expected at the end of the fiscal year. Cash flows during the year are enhanced because net income includes certain non-cash expense accruals which will not result in cash payments until September. These accruals are mainly for workers' compensation and Civil Service Retirement. Cash flows will be positive between now and September when those payments are made. The workers' compensation payment is estimated to be around $900 million and the retirement payment (under current legislation) to be $3.9 billion.

Other liabilities increased $2.1 billion. Retirement benefits payable are up $1.5 billion due to pay increases for CSRS workers and retiree COLA adjustments. The Workers' compensation liability, reflecting the estimated cost of employee injuries, has increased by $652 million. Employee accumulated leave is $272 million below last year-end balances.

POSTAL EQUITY

The Quarter 2 equity balance was negative $1.7 billion, versus a negative $3 billion on September 30, 2002. The net income generated from September 30th through February 21st produced a $1.3 billion improvement in net capital deficiency at quarter's end.

SUMMARY

Revenue and mail volume growth remain sluggish through the second quarter. However, tight control over expenses and resource usage resulted in net income that was $485 million YTD greater than planned.

OUTLOOK

Last June, Global Insight, the macroeconomic forecasting service to which the Postal Service subscribes, forecast Gross Domestic Product (GDP) to grow 3.3% in FY 2003. Since, Global Insight's FY 2003 GDP growth forecast has fallen to 2.6%. We think it likely that the economy will grow even less than this reduced rate, as seems to be presaged by the 0.3% decline in real Personal Consumption Expenditures in January, followed by a 0.4% decline in February.

Virtually all of the Postal Service's mail volume contains some type of marketing message, relates to financial activity, or supports consumer or business transactions. Because of this, the growth or decline of mail volume is linked to the performance of the economy. This, coupled with competition and continued diversion make this a particularly challenging year.

Management believes, as stated in the last quarterly outlook, that over the remainder of the year, revenue and volume growth will slow compared to Quarter 1 due to stronger quarters in the base comparison. It may be recalled that the Postal Service's Quarter 1 volumes last fiscal year plummeted by a record 5.5 percent in the aftermath of 9/11 and the anthrax attacks. Volume declines moderated in Quarters 2 though 4, when volume declined by 3.5%, 2.5% and 1.4%, respectively.

Volume grew by 1.5% in Quarter 1 of this year and, as previously mentioned, was flat in Quarter 2. In Quarter 3, Management believes that volumes will remain flat and expects that revenue growth will remain below 6%. This is well below the originally planned Quarter 3 revenue growth rate of 8.1%. Contributing to the reduced outlook are the weakness of the economy, uncertainty related to the outcome of the war in Iraq, and continued significant volume losses in the Priority Mail and Express Mail business.

The last outlook said that First-Class Mail volume for Quarter 2 was expected to be unchanged from last year's level, due to the weakness of the economic recovery and continuing inroads by electronic alternatives. Total First-Class Mail volume actually declined by 1.6%, due to an unexpected decline in workshare volume. Consequently, expectations for workshare volume growth have been reduced. Declines in First-Class volume are expected to continue through the rest of this year.

The last outlook also said that large declines in Priority Mail and Express Mail volumes were expected, as their year over year growth rates continued to be affected by the rate increases, and by volume diverting to alternative services. Double digit declines were actually experienced in Quarter 2 and are expected to persist in Quarter 3.

The last outlook said that Periodicals volume would decline for the 7th consecutive quarter, but that the rate of decline was expected to moderate, consistent with the recent upturn of monthly advertising revenues in consumer magazines. The decline, in fact, moderated from a 5.2% rate in Quarter 1 to a 3.6% rate in Quarter 2. The rate of decline is expected to further moderate in Quarter 3, but note that the Magazine Publishers Association reported a meager 1.8% increase in advertising pages in February. This may signal further declines in advertising pages and hasten Periodicals volume losses.

The last outlook said that Standard Mail volume was projected to grow in Quarter 2 and could be the only significant source of volume growth. Standard Mail volume actually grew by 497 million pieces, or 2.7% over the same period last year. This was the only source of significant volume growth to offset the volume declines in First-Class Mail and Periodicals. Similar volume growth is expected in Quarter 3, but note that the uncertain economic situation and war in Iraq could negatively affect this outlook.

The last outlook said that Package Services volume was expected to decline slightly, consistent with the overall domestic package market. Package Services volume actually grew by 18 million pieces or 6.9%, led by a 6 million piece increase in Parcel Post volume and an 11 million piece increase in the volatile Bound Printed Matter category. Package Services volume increases are expected again in Quarter 3.

On the expense side, management is projecting favorable impacts in Quarter 3 from implementation of expense reduction plans as outlined in the Transformation Plan, low inflation rates and continued stringent cost controls. As previously noted, expenses in Quarters 1 and 2 were well below plan and only slightly above last year. Similar results are likely in Quarter 3 of this year.

Field Operations has been effective in matching work hour usage to declining workload over the last two years. More recently, significant progress has been made in controlling the growth of non-personnel expenses.

The favorable expense outlook will not be able to overcome the shortfall expected in Quarter 3 revenue. Therefore, the outlook for achieving the Quarter 3 net income plan of $336 million is unfavorable.

This outlook is subject to considerable risk. On the expense side, for example, fuel and other input prices could become volatile and erode operating margins. On the revenue and volume side, diversion could accelerate or the economy could fall into a double dip recession.

On the positive side, the analysis of the Postal Service's funding of the Civil Service Retirement System (CSRS), released by the Office of Personnel Management (OPM) in December, concluded that the Postal Service will contribute substantially more funds than necessary using the current funding formula. Under the revised formula, the Congressional Budget Office has estimated that the Postal Service's FY 2003 contribution could be at least $3.5 billion less than the amount included in our current plan. Legislation has been introduced in both the House and the Senate to revise the current contribution formula. If passed into law, this will have a material impact on the Postal Service's financial position and operating results.

For more details, link to: http://www.usps.com/financials/_pdf/ap0603.pdf

Income Statement
Quarter 2, FY 2003
(Unaudited)

($ in Millions)	Quarter Ending February 21, 2003	Quarter Ending February 22, 2002	Year-To-Date February 21, 2003	Year-To-Date February 22, 2002
Operating Revenue	**$ 16,427**	**$ 15,606**	**$ 32,756**	**$ 30,992**
Operating Expenses:				
Compensation and Benefits	12,151	12,076	24,125	$ 23,726
Transportation	1,287	1,358	2,415	$ 2,493
Other	1,895	1,939	3,657	$ 3,765
Total Operating Expenses	**15,333**	**15,373**	**30,197**	**$ 29,984**
Income From Operations	**1,094**	**233**	**2,559**	**$ 1,008**
Interest and Investment Income	12	7	23	$ 15
Interest on Deferrred Retirement	(371)	(379)	(743)	$ (757)
Interest Expense on Borrowing	(90)	(78)	(185)	$ (160)
Net Income (Loss)	**$ 645**	**$ (217)**	**$ 1,655**	**$ 106**

Based on Postal Fiscal Year

Balance Sheet

($ in Millions)	Feb. 21, 2003*	Sept. 30, 2002
ASSETS		
Current Assets		
Cash & Cash Equiv.	$ 1,625	$ 1,156
Other Current Assets	1,191	1,124
Total Current Assets	2,816	2,280
Property Plant & Equipment - Net	23,787	24,136
Deferred Retirement Costs	32,893	32,231
Other Assets	368	368
Total Assets	**59,864**	**59,015**

	Feb. 21, 2003*	Sept. 30, 2002
LIABILITIES		
Current Liabilities	12,843	11,771
Total Debt	7,475	11,115
Other Liabilities	41,221	39,131
Total Liabilities	**$ 61,539**	**$ 62,017**
EQUITY		
Government Capital Contributions	$ 3,034	$ 3,034
Deficit Since Reorganization	(4,709)	(6,036)
Total Equity (Capital Deficiency)	**$ (1,675)**	**$ (3,002)**
Total Liabilities & Equity	**$ 59,864**	**$ 59,015**

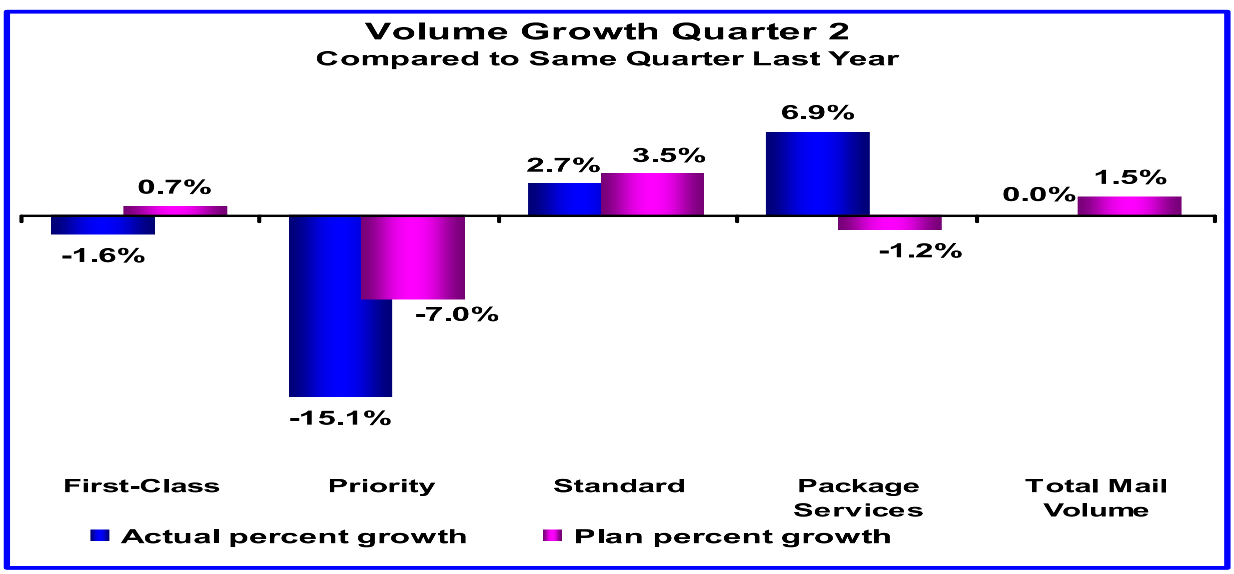
* Unaudited

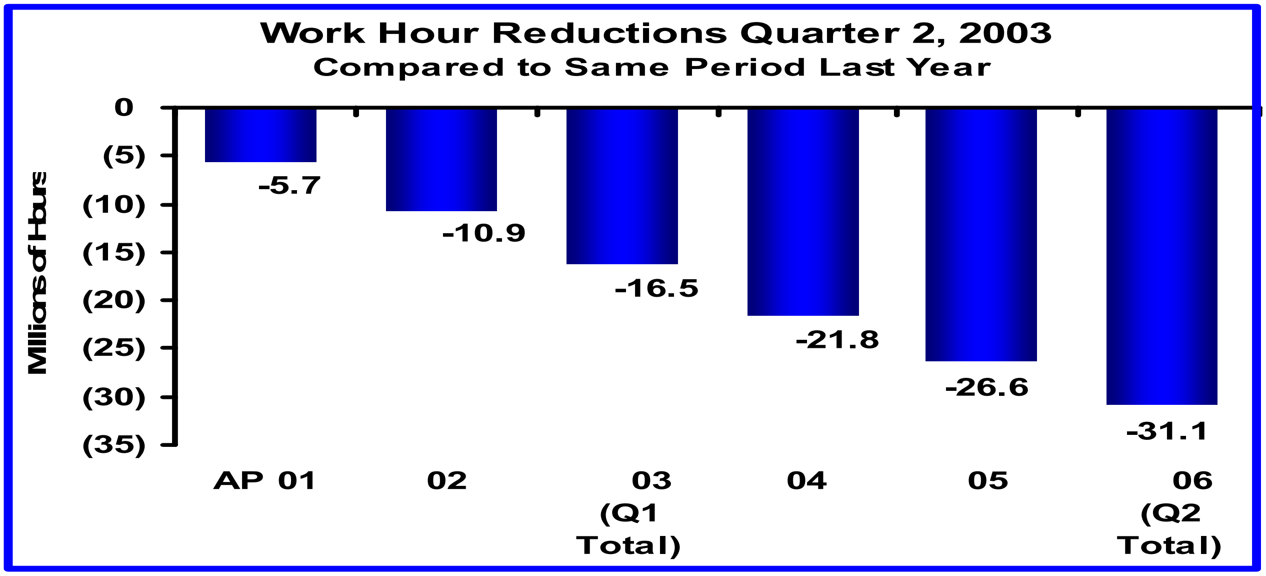
Based on Government Fiscal Year

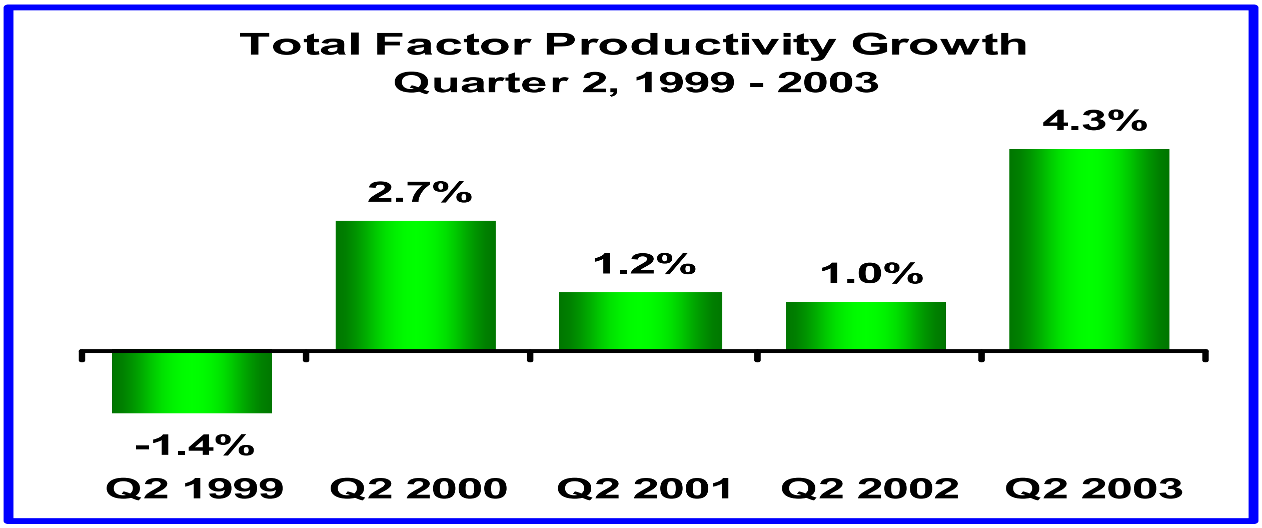
Statement of Cash Flows
October 1, 2002 through February 21, 2003

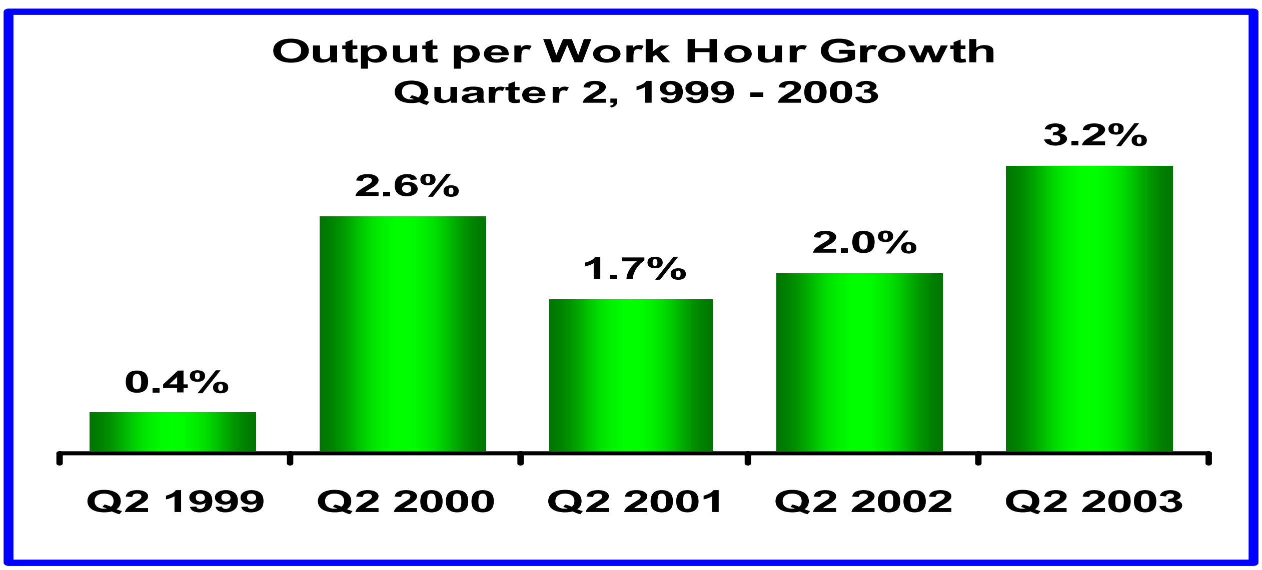
($ in Millions)	Feb. 21, 2003*	Sept. 30, 2002
Cash Flows from Operating Activities:		
Net Income (Loss) (Government Fiscal Year)	$ 1,327	$ (676)
Depreciation and Amortization	1,038	2,296
Changes in Non-Current Assets & Liabilities	1,428	892
Changes in Current Assets & Liabilities	1,005	(1,081)
Net Cash Provided by Operating Activities	**4,798**	**1,431**
Cash Flows from Investing Activities:		
Sale/Purchase of U. S. Government Securities - Net	-	(1,705)
Purchase of Property and Equipment - Net	(689)	42
Net Cash Used by Investing Activities	**(689)**	**(1,663)**
Cash Flows from Financing Activities:		
Increase/(Decrease) in Long-term Debt	(3,640)	383
Net Cash Used by Financing Activities	**(3,640)**	**383**
Net Change in Cash and Cash Equivalents	**469**	**151**
Cash & Cash Equivalents at Beginning of Period	1,156	1,005
Cash & Cash Equivalents at End of Period	**$ 1,625**	**$ 1,156**

Based on Government Fiscal Year
* Unaudited




Work Hour Reductions Quarter 2, 2003
Compared to Same Period Last Year
Millions of Hours
0
(5)
(10)
(15)
(20)
(25)
(30)
(35)
-5.7
-10.9
-16.5
-21.8
-26.6
-31.1
AP 01
02
03 (Q1 Total)
04
05
06 (Q2 Total)


Total Factor Productivity Growth
Quarter 2, 1999 - 2003
-1.4%
2.7%
1.2%
1.0%
4.3%
Q2 1999
Q2 2000
Q2 2001
Q2 2002
Q2 2003


Output per Work Hour Growth
Quarter 2, 1999 - 2003
0.4%
2.6%
1.7%
2.0%
3.2%
Q2 1999
Q2 2000
Q2 2001
Q2 2002
Q2 2003