United States Postal Service

475 L'Enfant Plaza, SW
Washington, DC 20260

202-268-2000
www.usps.com

Quarterly Financial Report

For the Three and Six Months Ended March 31, 2006

May 10, 2006

Part I. Financial Information

	PAGE
Item 1. Financial statements	
Statements of Operations Three and Six months ended March 31, 2006 and 2005	3
Balance Sheets March 31, 2006 and September 30, 2005	4-5
Statements of Changes in Net Capital Six months ended March 31, 2006 and year ended September 30, 2005	6
Statements of Cash Flows Six months ended March 31, 2006 and 2005	7
Notes to Financial Statements	8-10
Item 2. Management's discussion and analysis of results of operations and financial condition	11-26
Item 3. Quantitative and qualitative disclosures about market risk	26
Item 4. Controls and procedures	27

Part II. Other Information

Item 1. Legal proceedings	27
Item 5. Other information	27-29

Part I. Financial Information

Item 1. Financial Statements

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

	Three Months Ended March 31, 2006 (unaudited)	Three Months Ended March 31, 2005 (unaudited)	Six Months Ended March 31, 2006 (unaudited)	Six Months Ended March 31, 2005 (unaudited)
Operating revenue	**$ 18,615**	$ 17,296	**$ 37,113**	$ 36,082
Operating expenses:				
Compensation and benefits	**13,874**	13,480	**27,974**	27,147
Transportation	**1,527**	1,298	**3,036**	2,717
Other	**2,340**	2,208	**4,461**	4,181
Total operating expenses	**17,741**	16,986	**35,471**	34,045
Income from operations	**874**	310	**1,642**	2,037
Interest and investment income	**37**	19	**64**	30
Interest expense on deferred retirement obligations	**(65)**	(54)	**(131)**	(109)
Other Interest expense	**-**		**(1)**	(1)
Net Income	**$ 846**	$ 275	**$ 1,574**	$ 1,957

See accompanying notes to the financial statements.

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

	March 31, 2006 (unaudited)	September 30, 2005
Assets		
Current assets:		
Cash and cash equivalents	**$ 2,907**	$ 930
Receivables:		
Foreign countries	**568**	590
U.S. government	**293**	280
Other	**190**	188
Receivables before allowances	**1,051**	1,058
Less allowances	**48**	50
Total receivables, net	**1,003**	1,008
Supplies, advances and prepayments	**160**	200
Total current assets	**4,070**	2,138
Other assets, principally revenue forgone appropriations receivable	**388**	376
Property and equipment, at cost:		
Buildings	**20,826**	20,480
Equipment	**19,179**	18,664
Land	**2,879**	2,878
Leasehold Improvements	**1,206**	1,172
	44,090	43,194
Less allowances for depreciation and amortization	**23,284**	22,400
	20,806	20,794
Construction in progress	**1,891**	1,895
Total property and equipment, net	**22,697**	22,689
Total Assets	**$ 27,155**	$ 25,203

See accompanying notes to financial statements.

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

	March 31, 2006 (unaudited)	September 30, 2005
Liabilities and Net Capital		
Current liabilities:		
Compensation and benefits	**$ 3,047**	$ 2,852
Estimated prepaid postage	**1,221**	1,200
Payables and accrued expenses:		
Commercial vendors and accrued expenses	**1,285**	1,568
Foreign countries	**572**	688
U.S. Government	**58**	76
Total payables and accrued expenses	**1,915**	2,332
Customer deposit accounts	**1,697**	1,720
Outstanding postal money orders	**849**	830
Prepaid box rent and other deferred revenue	**454**	477
Total current liabilities	**9,183**	9,411
Non-current liabilities:		
Workers' compensation	**7,271**	6,695
Employees' accumulated leave	**2,044**	2,016
Deferred revenue	**692**	692
Long-term portion capital lease obligations	**659**	644
Other	**356**	369
Total non-current liabilities	**11,022**	10,416
Total Liabilities	**20,205**	19,827
Net capital:		
Capital contributions of the U.S. Government	**3,034**	3,034
Retained earnings since reorganization	**3,916**	2,342
Total Net Capital	**6,950**	5,376
Total Liabilities and Net Capital	**$ 27,155**	$ 25,203

See accompanying notes to financial statements.

United States Postal Service
Statements of Changes in Net Capital

Six months ended March 31, 2006 and the year ended September 30, 2005
(Dollars in millions)

	Capital Contributions of U.S. Government	Retained Earnings Since Reorganization	Total Net Capital
Balance, September 30, 2004	$ 3,034	$ 897	$ 3,931
Net Income	-	1,445	1,445
Balance, September 30, 2005	3,034	2,342	5,376
Net Income– Six months ended March 31, 2006 (unaudited)	-	1,574	1,574
Balance, March 31, 2006 (unaudited)	**$ 3,034**	**$ 3,916**	**$ 6,950**

See accompanying notes to financial statements.

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

	Six months ended March 31, 2006 (unaudited)	Six months ended March 31, 2005 (unaudited)
Cash flows from operating activities:		
Net Income	**$ 1,574**	$ 1,957
Adjustments to reconcile net income		
to net cash provided by operating activities:		
Depreciation and amortization	**1,074**	1,011
Loss on disposals of property and equipment, net	**4**	7
Increase in revenue forgone appropriations receivable	**(12)**	-
Increase in USPS workers' compensation liability	**576**	600
Increase in employees' accumulated leave	**28**	68
Increase in long-term portion capital lease obligations	**15**	4
(Decrease) increase in other non-current liabilities	**(13)**	448
Changes in current assets and liabilities:		
Decrease (increase) in receivables, net	**5**	(56)
Decrease in supplies, advances and prepayments	**40**	56
Increase in compensation and benefits	**195**	59
Increase in estimated prepaid postage	**21**	5
Decrease in payables and accrued expenses	**(417)**	(529)
(Decrease) increase in customer deposit accounts	**(23)**	76
Increase in outstanding postal money orders	**19**	29
(Decrease) increase in prepaid box rent and other deferred revenue	**(23)**	10
Net cash provided by operating activities	**3,063**	3,745
Cash flows from investing activities:		
Purchase of property and equipment	**(1,098)**	(1,050)
Proceeds from sale of property and equipment	**12**	11
Net cash used in investing activities	**(1,086)**	(1,039)
Cash flows from financing activities:		
Payments on debt	**-**	(1,800)
Net cash used in financing activities	**-**	(1,800)
Net increase in cash and cash equivalents	**1,977**	906
Cash and cash equivalents at beginning of year	**930**	877
Cash and cash equivalents at end of period	**$ 2,907**	$ 1,783
Supplemental Data		
Cash paid during the year for Interest	**$ -**	$ -

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 six months ended March 31, 2006 and March 31, 2005. 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 2005 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, The Postal Civil Service Retirement System Funding Reform Act of 2003 (P.L.108-18), is calculated by the Office of Personnel Management (OPM). The actual results experienced may differ from estimates.

Certain comparative prior year amounts in the financial statements and accompanying notes have been reclassified to conform to the current year presentation. These reclassifications had no effect on previously reported operating income and net income.

In the opinion of management, the accompanying unaudited financial statements reflect all adjustments (including normal recurring adjustments) necessary to present fairly our financial position as of March 31, 2006 and the results of our operations for the three- and six-month periods ended March 31, 2006 and 2005 and our cash flows for the six-month periods ended March 31, 2006 and 2005. Operating results for the three- and six-month periods ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending September 30, 2006.

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.

Retirement contributions for current employees in the second quarter of 2006 were $1,731 million compared to $1,673 million in 2005. For the first half of the year, contributions were $3,475 million compared to $3,393 million in 2005.

We also are required by P.L.108-18 to pay an additional annual amount known as a "supplemental liability", if necessary, each September, beginning in 2004, as determined by OPM. 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 2005, OPM estimated the total "supplemental liability" to be $4,200 million as of September 30, 2004. The September 30, 2003 "supplemental liability" was estimated to be $3,500 million. Our payment for 2005 was $290 million, and for 2004 was $240 million.

For the six months ended March 31, 2006 we have accrued $145 million for the estimated "supplemental liability" payable on September 30, 2006 compared to $120 million accrued as of March 31, 2005.

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 and Filtration Systems, Biohazard Detection Systems and an irradiation facility. For both appropriations, revenue is recognized as the capital equipment that was purchased with the appropriations, is depreciated. Funds for capital items that have not been offset against depreciation expense are shown on our balance sheet as deferred revenue ($43 million current, $692 million non-current). For the second quarter we recorded depreciation expense and associated appropriations revenue totaling $20 million for 2006 and $13 million in the second quarter of 2005. In the first half of 2006, we have recorded $37 million in revenue compared to $15 million in the first half of 2005. This brings the total revenue recognized from the 2002 appropriation to $355 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 March 31, 2006, our financial commitment (resources on order) for approved capital projects in process is $2,764 million.

Rents

At March 31, 2006 our future minimum lease payments for all non-cancelable leases are as follows:

Future Minimum Lease Payments
(Dollars in millions)

	March 31, 2006	
Year	**Operating**	**Capital**
2006	**$ 366**	**$ 53**
2007	**725**	**104**
2008	**704**	**102**
2009	**660**	**99**
2010	**608**	**95**
After 2010	**5,450**	**542**
	$ 8,513	**995**
Less: Interest at 5.25%		**303**
Total Capital Lease Obligations		**692**
Less: Short-term Portion of Capital Lease Obligations		**33**
Long-term Portion of Capital Lease Obligations		**$ 659**

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 $906 million at March 31, 2006 and $906 million at September 30, 2005. Total accumulated amortization related to capital leases was $341 million at March 31, 2006 and $318 million at September 30, 2005. Amortization expense for capital lease assets is recorded as depreciation expense.

Note 6 – Contingent Liabilities

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

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

Contingent Liabilities (Dollars in millions)	March 31, 2006	September 30, 2005
Labor cases	$ 292	$ 308
Equal Employment Opportunity cases	79	79
Tort cases	49	49
Environmental cases	25	25
Contractual cases	11	8
Total	$ 456	$ 469

Management and General Counsel believe that we have made adequate provision for the probable amounts due under the suits, claims and proceedings we have discussed here. Amounts we expect to pay in the next year are current liabilities on the balance sheets under the heading “Commercial vendors and accrued expenses.” The long term portion of the liability is accrued under the heading “Other Non-Current Liabilities.”

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 2005 Annual Report. All references to years, unless otherwise stated, refer to our fiscal year beginning October 1^{st} and ending September 30^{th}.

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 (PRC).

Our products are distributed through 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 approximately 145 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. Our physical infrastructure and 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, product management, and generation of revenues are 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. No single customer represents more than two 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. 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), nor are we required to produce, publish or file financial reports that comply with the SEC's rules and regulations on financial reporting. However, we voluntarily comply with SEC reporting requirements to the extent deemed practical for a non-publicly traded, government-owned entity with a breakeven mandate. Additionally, the Postal Service makes disclosures not required by the SEC reporting rules through the publication of certain reports that the Postal Service either must make, or chooses to make, public. These additional disclosures 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 on our website, at www.usps.com/financials.

Results of Operations

Operating Revenue for the second quarter benefited from the implementation of our across the board average rate increase of approximately 5.4 percent on January 8, 2006. Operating revenue in the second quarter was $18,615 million, compared to $17,296 million in the corresponding quarter last year. This 7.6 percent revenue increase was accompanied by a volume increase of 1,137 million pieces or 2.2 percent. The largest component of the revenue increase came from First-Class Mail which experienced a $536 million increase in revenue or 5.9 percent.

Operating revenue in the first half of 2006 was $37,113 million, compared to $36,082 million for the same period last year. This revenue increase of 2.9 percent was accompanied by a volume increase of 253 million pieces or 0.2 percent. The largest component of the revenue and volume increase came from Standard Mail which experienced a $351 million increase in revenue or 3.6 percent and a 780 million increase in volume or 1.5 percent.

Summary of Interim Financial Results

Three Months Ended March 31, 2006	2005	% Change	Financial Results (Dollars in millions)	Six Months Ended March 31, 2006	2005	% Change
$ 18,615	$ 17,296	7.6%	Operating revenue	$ 37,113	$ 36,082	2.9%
			Operating expense			
13,874	13,480	2.9%	Compensation and benefits	27,974	27,147	3.1%
1,527	1,298	17.6%	Transportation	3,036	2,717	11.7%
631	605	4.2%	Supplies and services	1,120	1,044	7.3%
544	512	6.2%	Depreciation and amortization	1,074	1,011	6.2%
1,165	1,091	6.9%	Other expenses	2,267	2,126	6.7%
17,741	16,986	4.4%	Total operating expense	35,471	34,045	4.2%
874	310	NM	Income from operations	1,642	2,037	NM
37	20	88.4%	Interest and investment income	64	30	111.2%
-65	-54	20.4%	Interest on deferred retirement obligations	-131	-109	20.4%
-	-1	NM	Interest expense on borrowings	-1	-1	NM
$ 846	$ 275	NM	Net Income	$ 1,574	$ 1,957	NM

Note: Percentages are calculated based on unrounded numbers.

NM: Not Meaningful to present as % difference

For the second quarter, operating expenses grew by 4.4 percent. Compensation and benefits expense contributed to most of the increase over the same period last year. Transportation and other fuel related expenses, driven by higher jet fuel, diesel, and gasoline prices, contributed significantly to expense growth. Supplies and services expense growth slowed from the first quarter. Other non-personnel expenses, which include a number of fuel-sensitive items also increased.

In the first half of 2006, the trend of increasing operating expenses continued with growth of 4.2 percent. Compensation and benefits expense contributed a large portion of the overall expense increase versus the same period last year. Transportation and other fuel related expenses, for the reasons mentioned above, also contributed significantly to expense growth. Supplies, services and other non-personnel expenses also increased.

Net income of $846 million for the second quarter showed an increase of $571 million when compared to the comparable quarter last year.

In the first half of 2006 net income was $1,574 million or a decrease of $383 million from the comparable period last year.

Effect of P.L.108-18 and use of "Savings"

As discussed below the net income of $1,574 million is $74 million above an allocation of $1,500 million for one half of a required $3 billion of "savings" required to be held in escrow on September 30, 2006.

P.L.108-18 identifies "savings" as the difference between the contributions we would have made to the Civil Service Retirement and Disability Fund (CSRDF) had the legislation not been enacted, and the contributions we now make under the law. In 2003 and 2004 we were required to use these "savings" to reduce our debt. In 2005 we paid our remaining debt of $1.8 billion, and used the remainder of the "savings" to offset operational expenses and hold postage rates constant for a third consecutive year.

Any "savings" after 2005 must be held in escrow. To fund the 2006 escrow requirement, we increased most postal rates and fees by 5.4 percent effective January 8, 2006.

Although the law directs this escrow funding requirement to be an operating expense, generally accepted accounting principles (GAAP) do not allow for this treatment. Under GAAP accounting rules, our September 30, 2006 financial statements will show approximately $3 billion as restricted cash on the balance sheet, not as an expense. However, management must operate as if the escrow is an expense since restricted cash cannot be used for operations.

This translates to a quarterly amount of $750 million. If the escrow were reported as an expense, we would have a net income of $96 million for the three months ended March 31, 2006 and $74 million for the first half of 2006.

	Three Months ended March 31, 2006	Six Months ended March 31, 2006
Total Revenue	$ 18,652	$ 37,177
Total Expense	17,806	35,603
Net Income (GAAP Basis)	846	1,574
Escrow Allocation	750	1,500
Net Income	$ 96	$ 74

Operating Revenue and Volume Analysis

Volume Analysis

In First-Class Mail, single-piece letters decreased 0.2 percent while workshare letters increased 2.5 percent in the second quarter. First-Class card volume rose 3.3 percent in the second quarter over the same period last year. Single-piece letter trends reflect the diversion of mail to electronic media, such as automatic bank account deductions, payments by credit cards and Internet bill payments. The negative impact of these electronic diversions more than offsets the positive impact of economic and population growth. Electronic diversion is thought to play a smaller role in the volume trends of workshare letters.

Through the first half of 2006, the volume of First-Class single-piece letters decreased 3.5 percent while workshare letters increased 0.5 percent. First-Class card volume rose 0.5 percent for the first half of the year. This activity reflects a continuation of the trend discussed above.

The changing mail mix reflects the persistent and gradual erosion of single-piece letter volume at a time when advertising by mail continues to maintain its share of the advertising market. Standard Mail volume grew only 2.7 percent in the second quarter. Regular rate and Enhanced Carrier Route (ECR) Standard volume, used by commercial advertisers, grew 3.3 percent in Quarter 2. This was the slowest growth rate of commercial Standard volume since the advertising slowdown in 2001-2002. Nonprofit Standard Mail volume declined 0.4 percent in the second quarter.

Standard Mail volume exceeded First-Class Mail volume for the first half of the year. This relationship is expected to continue into the future. Standard Mail volume grew 1.5 percent for the first half of the year. Regular rate and ECR Standard Mail volume grew by 2.8 percent for the first half of the year. Nonprofit Standard Mail volume declined 5.4 percent for the first half of the year. This decline is influenced by the election cycle. (A presidential election occurred in Quarter 1 of 2005).

Periodicals volume increased in the second quarter by 0.3 percent. This is unusual in the context of a well established trend of declining volume.

Periodicals volume declined by 0.9 percent in the first half of the year. These results are typical of Periodicals Mail and reflects the decline in magazine and newspaper circulation.

Package Services volume increased in the second quarter by 3.4 percent. Parcel Post volumes fell 5 percent in the second quarter. This result reflects the impact of the rate increase, and possibly, the bankruptcy of a major parcel consolidator. Increases in fuel prices have caused increased costs for parcel consolidators who use Parcel Select service. Bound Printed Matter volume grew 9.2 percent for the quarter. Quarter 2 was the 13th quarter in the last 14 quarters for which Bound Printed Matter exhibited positive volume growth. Media Mail volume was virtually unchanged from the second quarter of 2005. Library Mail volume grew 30.3 percent in the second quarter after declining 16.2 percent in the first quarter.

For the first half of 2006, Package Services volume grew 3.6 percent while revenue increased 0.4 percent, compared to the first half of 2005. During the same time period, Parcel Post volumes fell 4.2 percent. Bound Printed Matter volume grew 10.6 percent for the first half of the year, and continued the trend of positive volume growth mentioned above. Media Mail volume grew by 0.3 percent, while Library Mail volume grew 5.3 percent during the first half of 2006.

Priority Mail volume increased in the second quarter by 10.1 percent. This is the seventh consecutive quarter of volume gains for Priority Mail. Four factors underlie this performance. First, we have worked to consistently improve Priority Mail service performance. Second, Priority Mail is increasingly easy to use. 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 commercial websites such as eBay. Carrier pickup saves customers a trip to the Post Office and our flat rate envelope and flat rate box simplify Priority Mail use further. Third, prior to the January 8, 2006 rate increase, Priority Mail rates had not changed since June 2002, while competitors' published rates have increased almost annually during the same period. Finally, 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

Priority Mail volume increased in the first half of the year by 7 percent. This is, as mentioned above, a continuation of a trend of volume gains for Priority Mail.

Express Mail volume grew 2.2 percent in the second quarter. This is the sixth straight quarter of volume gains for Express Mail. Like Priority Mail, Express Mail has benefited from website access on www.usps.com, continued rate stability, and the impact of surcharges imposed by private sector competitors. We do expect some continued sluggishness in growth in the short term for this class due to the initial impact of our January price increase.

Express Mail experienced positive growth of 3.9 percent in the first half of 2006. Again, as mentioned above, this continues a trend of positive growth.

International Mail originating in the United States decreased in the second quarter and first half of 2006 by 3.1 percent and 2.1 percent, respectively.

"Other" volume, in the table on page 15, includes mail sent by the U.S. Postal Service and Free Matter for the Blind and Handicapped. Volume from "Other" mail, which represents only 0.5 percent of total mail volume, grew 71.7 percent in the second quarter of 2006 versus 2005. This growth was mainly as a result of a promotional campaign underwritten by us. "Other" mail volume grew 32.6 percent in the first half of 2006 compared to the same period last year.

Volume by Class of Mail

Three months ended March 31			Class of Mail	Six months ended March 31		
2006	2005	% change	(Pieces in millions)	2006	2005	% change
24,998.8	24,656.6	1.4%	First-Class Mail	50,432.8	51,084.8	-1.3%
24,985.3	24,327.5	2.7%	Standard Mail	52,061.3	51,281.8	1.5%
2,296.8	2,290.5	0.3%	Periodicals	4,591.3	4,630.7	-0.9%
298.0	288.3	3.4%	Package Services	624.8	602.9	3.6%
240.9	218.8	10.1%	Priority Mail	490.4	458.4	7.0%
14.1	13.8	2.2%	Express Mail	28.3	27.3	3.9%
194.8	201.0	-3.1%	International	440.5	450.1	-2.1%
251.0	146.2	71.7%	Other	484.8	365.6	32.6%
53,279.7	52,142.7	2.2%	Total Mail Volume	109,154.2	108,901.6	0.2%

Note: Percentages are calculated based on unrounded numbers.

Revenue Analysis

Based on stable postage rates between June 2002 and January 2006, changes in revenue performance were expected to be highly correlated with changes in mail volume. Differences between revenue and volume growth rates under these circumstances are attributable to mail mix changes within the categories reported herein. Specifically, if volume growth in a particular mail class exceeds revenue growth, this indicated that low yield volume (in terms of revenue per piece) within the class was growing faster than high yield volume. It basically held true that if volume growth exceeded revenue growth, our revenue per piece was declining.

Rates for most products and services increased, on average, 5.4 percent on January 8, 2006. Because of rate design considerations, some products and services of mail received increases slightly more or less than 5.4 percent. One product, in-county Periodicals, actually received a small rate decrease, while Parcel Post, Media Mail and Library Mail received considerably higher than average rate increases of 7.1, percent, 12.7 percent and 12.6 percent respectively.

First-Class Mail revenue grew 5.9 percent in Quarter 2. This increase was slightly greater than the 5.2 percent average increase in First-Class Mail rates implemented on the eighth day of the quarter.

For the first half of the year, First-Class revenue increased 0.6 percent. This small increase reflects the changing mix of First-Class letters. High-revenue per piece, single-piece letter volume is declining, while low-revenue workshare letters are growing.

Standard Mail revenue grew 7 percent in the second quarter. The rate increases for Standard Mail averaged approximately 5 percent for commercial Standard and 5.7 percent for Nonprofit Standard. A small mitigating factor in revenue growth was the fact that weight per piece (a determinant of Standard Mail revenue) fell slightly, by 1.2 percent.

As mentioned previously, a declining circulation base for newspapers and magazines limited Periodical Mail revenue growth to only 3.6 percent in the second quarter and 0.9 percent in the first half of the year. Weight per piece fell by 1.2 percent during that time.

Package Services revenue increased 5.8 percent in the second quarter. Package Services is composed of Parcel Post, Bound Printed Matter, Media Mail, Library Mail, and Domestic Mail Fees. Parcel Post accounted for just over 52 percent of Package Service revenue. For the second quarter, Parcel Post revenue increased only 0.3 percent following a 7.1 percent rate increase. The slow revenue growth is indicative of two changes in parcel post. First, retail parcel post is growing more slowly than Parcel Select, a discounted service. Second, the parcel post weight per piece declined by 5.9 percent in the quarter. Bound Printed Matter revenue grew 10.9 percent following a 5.5 percent rate increase. Media Mail revenue grew 12.6 percent this quarter. This growth is largely attributable to its 12.7 percent rate increase. Library Mail revenue (which constitutes less than 2 percent of Package Service revenue) grew 44.7 percent in the second quarter.

For the first half of the year, Package Services revenue increased 0.4 percent. Parcel Post accounted for almost 56 percent of Package Service revenue during this period. Parcel Post revenue declined by 5.1 percent, at the same time, Parcel Post weight per piece declined by 4.3 percent. This is more closely in line with the revenue decline mentioned above. Bound Printed Matter revenue grew 8.5 percent in the first half of the year. Media Mail grew 7.1 percent and Library Mail grew 12.4 percent.

Priority Mail revenue grew 18.4 percent in the second quarter. Most of this growth is attributed to Priority Mail's increasing value in the marketplace. It should also be noted that Priority Mail is experiencing a weight increase. The weight of Priority Mail grew 18.2 percent in the second quarter versus the second quarter of 2005. Express Mail revenue grew 7.4 percent in the second quarter compared to the same period last year. Some of this revenue growth is the result of the rate increase, but it also is indicative of a turnaround in volume. Like Priority Mail, Express Mail is also experiencing a weight increase of 3.1 percent in the second quarter.

Year-to-date, Priority Mail revenue grew 11.2 percent. As mentioned above, this growth is attributed to Priority Mail's increasing value in the marketplace as well as the continued weight increases. The weight of Priority Mail grew 12.5 percent in the first six months of the fiscal year compared to the first six months of 2005. Express Mail revenue grew 6.8 percent in the first half of the year. To a lesser degree, the rate increase is impacting this growth as well as the turnaround in volume mentioned above. Like Priority Mail, Express Mail is also experiencing a weight increase of 6.6 percent for the first half of the year.

Revenue from International Mail grew 15.3 percent in the second quarter of 2006, overcoming a volume decline of 3.1 percent for the period. In addition to the effects of the rate increase, this result reflects the shift in the mail mix from low yield Economy Mail to higher yield Air Mail.

Revenue from International Mail grew 8.4 percent in the first half of 2006 with a volume decline of 2.1 percent for the year. This is reflective of the same factors discussed previously for the quarter.

"Other" revenue, which includes special services increased $122 million, or 15.7 percent, in the second quarter. Second quarter revenue increases included Certified Mail $25 million and Delivery Receipt Services $20 million and Passport acceptance revenue $19 million.

For the first half of the year "Other" revenue increased $164 million or 10.6 percent. Again, Passport acceptance revenue, $32 million, Certified Mail revenue, $21 million, and Delivery Services revenue, $19 million, were the drivers of the revenue increase.

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

Revenue by Class of Mail

Three Months Ended March 31,			Class of Mail	Six Months Ended March 31,		
2006	2005	% change	(Dollars in millions)	2006	2005	% change
$ 9,595	$ 9,059	5.9%	First-Class Mail	$ 18,930	$ 18,808	0.6%
4,919	4,598	7.0%	Standard Mail	10,003	9,652	3.6%
560	541	3.6%	Periodical Mail	1,114	1,104	0.9%
583	551	5.8%	Package Services	1,202	1,197	0.4%
1,338	1,130	18.4%	Priority Mail	2,695	2,423	11.2%
231	215	7.4%	Express Mail	462	433	6.8%
488	423	15.3%	International *	1,009	931	8.4%
901	779	15.7%	Other	1,698	1,534	10.6%
$ 18,615	$ 17,296	7.6%	Total Operating Revenue	$ 37,113	$ 36,082	2.9%

Note: Percentages are calculated on unrounded numbers.

* International does not include revenue from in-bound postage originating at foreign postal facilities.

Operating Expenses

Compensation and Benefits and Workhour Analysis

Total compensation and benefits for the second quarter was $13,874 million, or 2.9 percent higher than the amount of $13,480 million one year prior. This increase of $394 million was driven mainly by an increase in wages of $194 million, $72 million in employee health benefits and an increase in retirement contributions of $58 million. Other factors were an increase in retiree health benefits of $38 million, a $23 million increase in workers compensation costs and a $9 million increase in other personnel costs.

Total compensation and benefits increased in the first half of 2006 to $27,974 million, or 3.1 percent higher than the prior year period amount of $27,147 million. This increase of $827 million was driven by an increase in wages of $494 million, $160 million in employee health benefits, and an increase in retirement contributions of $82 million. Retiree health benefits increased $79 million and other personnel costs increased $14 million with only a minor reduction of $2 million in workers' compensation costs.

Overall, benefits which include health benefits, for current and retired personnel as well as workers' compensation and retirement costs constituted over 28.1 percent of our total personnel compensation expenses in the second quarter and 27.7 percent in the first half of 2006.

Wages

Wages grew in the second quarter by $194 million compared to same period last year. This is due to increases in wage rates and overtime usage. Bargaining unit employees, except for the American Postal Workers Union (APWU), received pay increases of 1.3 percent in November 2005. In March 2006 APWU employees received a 1.6 percent increase. In addition, almost all bargaining unit employees received annualized cost of living adjustments (COLAs) in both March 2005 and September 2005. The September 2005 COLA, was the largest COLA since May 1980 and accounted for $141 million of the $194 million increase in wages. Included in the wage growth is the impact of a 0.1 percent growth in overtime hours in the second quarter. This contributed $30 million to the total wage increase.

Wages grew in the first half of 2006 by $494 million compared to the same period last year. This, as discussed above, contains significant COLA adjustments. The September 2005 COLA discussed above was responsible for $282 million of the $494 million increase in wages. Also included in the wage growth is the impact of a 2.7 percent growth in overtime hours. This contributed $136 million to the total wage increase.

Workhours

A change in workhours usually reflects 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. Delivery points are increasing currently at a rate of 2 million delivery points per year. This increase is factored in when comparing the current quarter and first half of the year to the prior periods.

In our second quarter, mail volume increased by 1.1 billion pieces, or 2.2 percent as compared to the same quarter last year. Total workhour usage increased 0.3 million hours, or 0.1 percent, from the comparable period last year. City Delivery, Mail Processing, and Administrative are the functions that decreased workhour usage. These functions accounted for 61.8% of total workhours in the second quarter.

In the first half of 2006, mail volume increased by 253 million pieces, or 0.2 percent as compared to the same period last year. Total workhour usage declined 0.7 million hours, or 0.1 percent, from the comparable period last year. Again, City Delivery, Mail Processing, and Administrative are the functions that decreased workhour usage.

Quarter 2 Workhours

Workhours in the mail processing function decreased by 0.7 million through implementation of initiatives to increase productivity using cost savings programs and improvements in operational efficiencies. Our 2006 Integrated Financial Plan provides an outline of these programs and operational efficiency efforts. Delivery growth resulted in a combined rural delivery and city delivery increase of 1 million workhours over the same quarter last year. The workload impact of this increase in the delivery network is equivalent to 2.3 million workhours with unchanged productivity. The reduced workhour utilization is therefore due to an increased productivity level of 1.5 percent in Quarter 2. Route inspections, which began in Quarter 2, will provide a basis for capturing savings in the future as city delivery routes are realigned or eliminated.

Workhours in administrative functions were 1.1 million less than the same quarter last year. This is due to a continued effort to reduce administrative costs.

Listed below are the workhours and salaries and benefits by Function for the second quarter of 2006 compared with the same period last year.

Compensation , Benefits and Workhour Analysis

Workhours Three Months Ended March 31, (In thousands)					Salaries and benefits Three Months Ended March 31, (Dollars in millions)		
2006	2005		% Change		2006	2005	% Change
				Salaries & Benefits by Function			
				Operations			
114,964	116,174		-1.0%	-City Delivery	$ 4,263	$ 4,150	2.7%
82,567	83,275		-0.9%	-Mail Processing	2,914	2,869	1.6%
62,094	61,371	*	1.2%	-Customer Services, Retail & Sales	2,085	1,999	4.3%
44,998	42,834		5.1%	-Rural Delivery	1,334	1,238	7.8%
20,390	20,235		0.8%	-Plant & Equip Maintenance	780	751	3.9%
7,989	7,916		0.9%	-Vehicles Services	308	297	3.7%
2,549	2,409		5.8%	-Operations Support	117	106	10.4%
25,715	26,799	*	-4.0%	Headquarter, Area & District Management, Postmasters, Administration and Other	1,250	1,317	-5.1%
361,266	361,013		0.1%	Subtotal	13,051	12,727	2.5%
Not Applicable				Other Compensation			
				Workers' Compensation	299	276	8.3%
				Retiree Health Benefits	419	381	10.0%
				Other	105	96	9.4%
361,266	361,013		0.1%	Total	$13,874	$13,480	2.9%

* Due to a change in the way customer service hours are calculated we have adjusted 2005 hours to be presented on a comparable basis. This presentation change has no effect on total hours

Note: Percentages are calculated based on unrounded numbers

Year-to-Date Workhours

In the first half of 2006, workhours in the mail processing function decreased by 1.4 million due to cost savings programs and improvements in operational efficiencies. Delivery growth resulted in increased workload in the delivery network equivalent to 4.6 million hours over the first six months of last year. Actual hours, however, rose by 2 million compared to the same period last year.

Again, due to a continued effort to reduce costs, workhours in administrative functions are 2.2 million less than the same period last year.

Listed below are workhours and salaries and benefits by Function for the first half of 2006 compared with the same period last year.

Compensation , Benefits and Workhour Analysis

Workhours Six Months Ended March 31, (In thousands)				Salaries and benefits Six Months Ended March 31, (Dollars in millions)		
2006	2005	% Change		2006	2005	% Change
			Salaries & Benefits by Function			
			Operations			
234,397	236,069	-0.7%	-City Delivery	$ 8,618	$ 8,381	2.8%
172,197	173,551	-0.8%	-Mail Processing	5,984	5,865	2.0%
125,533	125,244 *	0.2%	-Customer Services, Retail & Sales	4,199	4,059	3.4%
91,278	87,561	4.2%	-Rural Delivery	2,696	2,495	8.1%
40,693	40,542	0.4%	-Plant & Equip Maintenance	1,559	1502	3.8%
16,134	16,050	0.5%	-Vehicles Services	621	599	3.7%
4,907	4,648	5.6%	-Operations Support	224	204	9.8%
51,022	53,175 *	-4.0%	Headquarter, Area & District Management, Postmasters, Administration and Other	2,457	2,517	-2.4%
736,161	736,840	-0.1%	Subtotal	26,358	25,622	2.9%
Not Applicable			Other Compensation			
			Workers' Compensation	598	600	-0.3%
			Retiree Health Benefits	814	735	10.7%
			Other	204	190	7.4%
736,161	736,840	-0.1%	Total	$27,974	$27,147	3.1%

* Due to a change in the way customer service hours are calculated we have adjusted 2005 hours to be presented on a comparable basis. This presentation change has no effect on total hours

Note: Percentages are calculated based on unrounded numbers

Other Compensation

Workers' compensation costs represented approximately 2.2 percent of compensation and benefits expenses in the quarter, compared to 2.1 percent for the comparable period last year. 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. In fiscal year 2005, we experienced a 4.4 percent decrease in the number of paid medical claims and a 5.5 percent decrease in the number of paid compensation claims compared to fiscal year 2004. Through three quarters of the Department of Labor chargeback year (July 1, 2005-March 31, 2006), we have experienced a 4.5 percent decrease in the number of paid medical claims and a 2 percent decline in the number of paid compensation claims.

Retiree health benefits costs were about 3.1 percent of compensation and benefits expense in the second quarter, compared to 2.8 percent in the corresponding quarter last year. See Note 3 for a full description of the retiree health benefits program. The major drivers of Retiree Health Benefits expense are the number of participants on the rolls and inflation in premium costs. As of March 31, 2006, we had approximately 447,000 participants on the rolls, an increase of about 6,000 over the prior year. Our expense related to retiree health benefits was $419 million during this quarter, compared to $381 million in the same quarter of 2005, an increase of 10.0 percent.

Retiree health benefits costs were about 2.9 percent of compensation and benefits expense in the first half of 2006, compared to 2.7 percent in the corresponding period last year. Our expense related to retiree health benefits was $814 million during this period, compared to $735 million in the corresponding period last year, an increase of 10.7 percent.

Employee Complement

Employee complement was reduced by 6,368 during the quarter and 8,509 in the first half of 2006. The total number of career employees at the end of the quarter was 696,207. This represents a reduction of 6,568 employees from the same period last year, all through attrition.

Retirement Expense

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 2005 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 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 of $1,731 million for current employees, which are included in compensation and benefits expense, represented 9.7 percent of our total expenses during the second quarter. This is an increase of $58 million compared to the same period last year. During the first half of 2006 retirement expenses of $3,475 million were 9.8 percent of our total expenses, an increase of $82 million over the same period last year.

Transportation

Transportation expenses were $1,527 million, an increase of $229 million, or 17.5 percent, for the quarter. Through the first half of 2006 transportation costs were $3,036, an increase of $319 million, or 11.7 percent. Transportation costs are largely made up of air and highway transportation.

Air transportation expenses were $685 million, an increase of $107 million, or 18.5 percent, over the same quarter last year. This is primarily attributed to increased fuel charges and air mail volume for our dedicated air carrier. During the second quarter, the index on which jet fuel costs are based increased 64.2 percent from the same quarter last year, causing air transportation costs to increase approximately $41 million. Increased Air Mail volume accounted for $35 million in additional costs.

Year-to-date air transportation expenses were $1,386 million, an increase of $159 million, or 13.0 percent. This is primarily attributed to increased fuel charges as well as contractual rate increases for our dedicated air carrier. During the period, the index on which jet fuel costs are based increased 58.2 percent from the same period last year, causing air transportation costs to increase $84 million. Contractual rate increases accounted for about $21 million dollars of increased costs and air mail volume accounted for an additional $31 million in costs.

Tranportation Expenses

Three Months Ended March 31, 2006	Three Months Ended March 31, 2005	% Change	(Dollars in millions)	Six Months Ended March 31, 2006	Six Months Ended March 31, 2005	% Change
$ 685	$ 578	18.5%	Air Transportation	$ 1,386	$ 1,227	13.0%
755	649	16.3%	Highway Transportation	1,516	1,328	14.1%
87	71	21.1%	Other Transportation	134	162	-17.4%
$ 1,527	$ 1,298	17.5%	Total	$ 3,036	$ 2,717	11.7%

Highway transportation expenses increased by $106 million to $755 million, or 16.3 percent, over the same quarter last year. The increase was driven by higher fuel prices, contractual rate increases for drivers, as well as increased miles driven and increased trips by contract carriers. During the second quarter, retail gasoline prices increased an average of 21 percent from the same period last year. This resulted in increased fuel costs for highway contract operations of approximately $31 million for the second quarter. Additional miles driven accounted for an additional $17 million dollars in fuel charges. 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. This adjustment resulted in $19 million of additional costs in the second quarter.

Highway transportation expenses of $1,516 million increased by $188 million, or 14.1 percent, over the first half of last year. The increase was driven primarily by higher fuel prices and contractual rate increases for drivers. During this period, retail gasoline prices increased an average of 25 percent versus the same period last year. This resulted in increased fuel costs for highway contract operations of approximately $80 million. Due to network growth, additional miles driven accounted for an additional $27 million dollars in fuel charges. Contract payments to drivers resulted in additional costs of $37 million in the first half of 2006.

Other transportation expenses increased $16 million dollars in the second quarter and decreased $28 million dollars in the first half of 2006 due primarily to the timing of terminal dues payments to foreign postal administrations and related international expenses.

Supplies and Services

Supplies and services expenses of $631 million were $26 million or 4.2 percent higher in the second quarter than last year's comparable period. Services expense increased $46 million compared to the same quarter last year due to programs such as logistics support for Bio-detection Systems (BDS), mail transportation equipment service center costs, and debit/credit card processing costs and fees. These expenses were offset by a $21 million decrease in supplies expenses being primarily BDS cartridges.

Supplies and services expenses of $1,120 million were $76 million or 7.3 percent higher in the first half of 2006 than last year's comparable period. Expenses for professional and other services increased $88 million compared to the same period last year due to new programs such as logistics support for BDS. Offsetting expenses for professional and other services was a $24 million decrease in consulting services expenses.

Depreciation and Amortization

Depreciation expenses of $544 million were $32 million more than last year's comparable quarter. The depreciation increases are the result of higher capital investment in 2005 than in prior years. Depreciation of biohazard detection and ventilation and filtration systems contributed to $7 million of the increase in the second quarter. Additionally, an updated analysis of the useful life and salvage value of certain delivery vehicle assets resulted in an increase in depreciation expense of $12 million this quarter. This impact will continue for the next 11 years, decreasing over time as vehicles become fully depreciated.

Depreciation expenses were, in the first half of 2006, $1,074 million or $63 million more than last year's comparable period. Biohazard detection and ventilation and filtration systems depreciation increased $22 million in the first half of 2006. The depreciation expense of certain delivery vehicle assets increased $24 million in the first half of 2006 for the reasons mentioned above.

Other Expenses

Other expenses of $1,165 million were $75 million, or 6.9 percent higher than last year's comparable quarter. The major components are rent and utilities of $451 million, vehicle maintenance services of $169 million, rural carrier equipment maintenance allowances (RCEMA) of $126 million, and information technology (IT) and communications of $143 million. RCEMA has the greatest increase at $28 million or 28 percent. This is attributed to an additional pay date in the current quarter and increased delivery miles driven. Rent expense remained relatively flat while utilities increased by $24 million, or 14.6 percent, driven by electricity and natural gas costs. Vehicle maintenance services increased $23 million or 16.1 percent, as bulk fuel costs continued to rise. IT costs remained flat and communication expenses increased by $6 million, or 11 percent, as computer networks were upgraded.

Other expenses of $2,267 million were up $141 million in the first half of 2006, or 6.7 percent higher than last year's comparable period. As stated above the major components are rent and utilities of $854 million, vehicle maintenance services of $339 million, RCEMA of $237 million, and IT and communication expenses of $284 million. Vehicle maintenance services accounted for the largest increase at $55 million, or 20 percent, as bulk fuel costs rose. Utilities increased $48 million, or 16.7 percent, driven by electricity and natural gas costs. RCEMA increased $40 million, or 21 percent, due primarily to increased delivery miles driven. IT and communication expense increased $26 million, or 10 percent, for upgraded computer networks and increased automated data processing costs. These increases were mitigated by declines in advertising, and building projects expenses of $11 million and $12 million, respectively.

Interest Expense

Interest expense of $65 million was $11 million higher than last year's comparable quarter. Interest expense of $132 million in the first half of 2006 was $22 million higher than last year's comparable period. $131 million of the interest expense and the entire increase in interest expense is due to the CSRS supplemental retirement obligation. This obligation was last calculated by the Office of Personnel Management in June 2005.

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.

In the second quarter, TFP related workload increased by 2.2 percent, while resource usage increased 0.7 percent, yielding a 1.5 percent increase in TFP versus the same period last year. The workload increase was driven primarily by mail volume increase which contributed 1.6 percent to the workload growth. Continuing delivery network growth contributed an additional 0.5 percent to workload growth, while miscellaneous services contributed the remaining 0.1 percent. The 0.7 percent growth in resource usage was driven by increases in materials (0.4 percent) and capital (0.3 percent). Labor usage remained unchanged from the second quarter of last year.

In the first half of 2006, workload increased by 1.0 percent, while resource usage increased 0.7 percent. This yielded a 0.3 percent increase in TFP. This productivity increase is equivalent to an expense reduction of $98 million. The 1.0 percent workload increase was driven primarily by the continuing delivery network growth which contributed 0.5 percent to workload growth. Mail volume increases contributed 0.2 percent to workload growth and miscellaneous services contributed the remaining 0.3 percent. The 0.7 percent increase in resource usage was driven by increases in materials and capital usage which combined contributed 0.9 percent to the growth in resources usage. These increases were offset 0.2 percent by a reduction in labor usage.

Financial Condition

Debt and Liquidity

As of March 31, 2006, we had no outstanding debt with the U.S, Treasury's Federal Financing Bank, as was the case at September 30, 2005. Cash and cash equivalents were $2,907 million, $1,977 million higher than September 30, 2005, and $1,124 million higher than at the end of March 2005. The main driver of the increase in cash was the payoff of our debt in 2005. Last year, we used the net cash flow from operations to pay off $1.8 billion in debt. This year, with no debt to repay, the net cash flow increased our cash and cash equivalents balance.

For the first half of 2006, cash flow from operating activities was $682 million lower than the same period last year, while net cash used in investing activities (capital outlays) was $47 million higher. Last year after paying for capital investments and retiring our debt we had a reduction in cash of $140 million.

We do not anticipate any borrowing until the end of the fiscal year. In September, we anticipate approximately $1.2 billion in lump sum payments for workers' compensation and retirement liabilities. Additionally, we do not expect cash flow from operations for the year to supply enough cash to fund both the escrow requirement, estimated at $3 billion, and capital investments. Consequently, we anticipate increasing debt by over $1 billion in 2006.

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

Capital Expenditures and Commitments

The capital commitments through the first half of 2006 were $466 million compared to $757 million in the same period of 2005.

During the second quarter, the Board of Governors approved funding for three projects: a modification to the original Flat Sequencing System (FSS) and Delivery Point Packager, funding for the Remote Encoding System, and funding for the Northeast Metro Michigan Processing & Distribution Center (P&DC). The FSS modification authorizes funding to move the prototype machine to Indianapolis for live testing, and to design and fabricate a pre-production unit. The Remote Encoding System will develop concepts and technologies to replace the 15 year old obsolete Image Processing Subsystem that now supports image processing and Remote Bar Coding System operations for the letter mail automation equipment network. The NE Metro Michigan P&DC received full project approval for purchase of a 70 acre site, and design and construction of a new 850,000 square foot facility.

The capital cash outlays for the first half of 2006 were $1,098 million compared with $1,050 million during the first six months of 2005. The Capital Commitments, Expenditures, and Resources on Order table, below, summarizes activity for the first half of 2006 compared to same period last year.

Capital Commitments, Expenditures, and Resources on Order

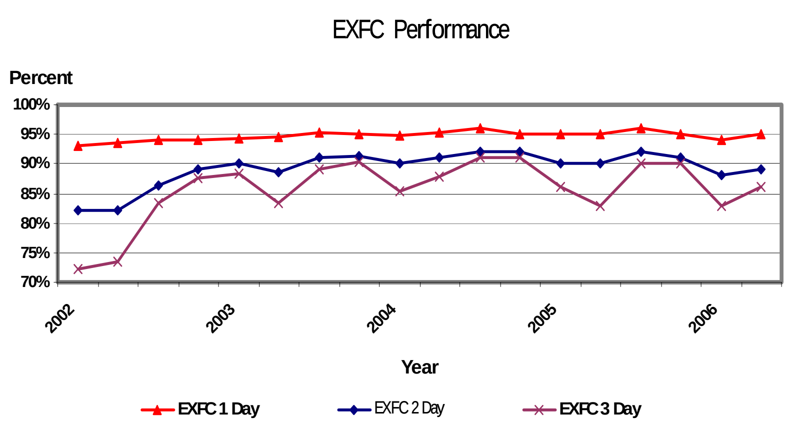
CAPITAL INVESTMENTS (Dollars in millions)	COMMITMENTS[1] Year to Date Through March 31, 2006	COMMITMENTS[1] Year to Date Through March 31, 2005	CASH OUTLAYS Year to Date Through March 31, 2006	CASH OUTLAYS Year to Date Through March 31, 2005	RESOURCES ON ORDER[2] March 31, 2006	RESOURCES ON ORDER[2] March 31, 2005
CONSTRUCTION AND BUILDING PURCHASE	$ 120	$ 99	$ 82	$ 109	$ 183	$ 179
BUILDING IMPROVEMENTS	166	74	242	195	337	256
MAIL PROCESSING EQUIPMENT	129	166	448	354	1,701	1,398
VEHICLES	13	20	117	107	99	32
RETAIL EQUIPMENT	-	3	1	50	38	48
POSTAL SUPPORT EQUIPMENT	38	395	208	235	406	560
TOTAL	$ 466	$ 757	$ 1,098	$ 1,050	$ 2,764	$ 2,473

(1) Capital Commitment - Binding agreements entered into by the Postal Service and vendors during the quarter for purchase of capital equipment, facilities, vehicles, or services, booked at the time the contract is signed.

(2) Resources on Order – All Capital Commitments that have not yet been paid.

Service and Performance

Management monitors several key statistics to determine performance against service standards and monitors 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 delivery performance from collection box to mailbox. 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. The EXFC Performance graph summarizes EXFC results by quarter since 2002. For the second quarter all categories showed improvement from the prior quarter. This is typical as we move from the winter months into spring. When compared to the comparable quarter of the prior year EXFC 1 day delivery was flat at 95 percent, EXFC 2 day delivery fell from 90 to 89 percent and EXFC 3 day delivery improved from 83 to 86 percent.

Customer Satisfaction

Performance has shown improvement across all levels from the prior quarter and is very comparable to the same period last year. However, because Quarter 1 performance took more of a dip than normal, we believe there will be some lag in customer satisfaction numbers returning to normally high levels. The independently measured customer satisfaction survey for residential household customers for the second quarter showed that 91 percent of these customers rated their experience with us as "excellent", "very good" or "good."

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 nation-wide or substantially nation-wide basis, to recommend decisions regarding rate complaints by interested parties, and to report complaints that parties are not receiving postal services in accordance with the requirements 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. Specific information on these pending dockets is on the PRC web site http://www.prc.gov.

On November 1, 2005, the PRC issued its Decision, on Docket No. R2005-1, to the Board of Governors. The Commission determined that the across-the-board increase suggested by the Postal Service will generate necessary revenues and is consistent with the public policies established by the Postal Reorganization Act. On November 14, 2005 the Governors voted to accept the Postal Rate Commission's recommendations. The new rates took effect January 8, 2006.

On May 3, 2006, we filed a case with the independent Postal Rate Commission (PRC) for price adjustments to go into effect no earlier than May 2007. The plan includes rate adjustments that increase an average of 8.5 percent. The plan includes a three-cent increase in the price of a First-Class stamp. The annual effect is well below $6 for the average household.

The Governors of the U.S. Postal Service also proposed a "forever stamp" as part of the broader rate adjustment plan. Customers would be able to purchase a special First-Class stamp that would be good for any future single-piece First-Class letter mailing, no matter how prices might change beyond 2007.

Outlook

The outlook for the remainder of 2006 is challenging. Revenue growth for the remainder of the year will be driven by the impact of our January 2006 rate increase. Expense growth for the year will likely be comparable in 2006 to 2005. Sustained high fuel prices throughout the year and higher wage rates, primarily driven by larger COLAs for our bargaining employees, are the main drivers behind the expense growth.

Revenue Outlook

The revenue outlook for the remainder of the year remains positive but guarded. The 5.4 percent rate increase implemented on January 8, 2006 should act to depress mail volume growth slightly for the remainder of the year. However, revenues should increase.

Although growth in economic activity slowed to 1.7 percent in the first postal quarter of 2006, real GDP growth rebounded to 4.8 percent in Quarter 2. Macroeconomic forecaster Global Insight is calling for real GDP growth to slow from Quarter 2 and end the fiscal year at 3.3 percent.

Three economic variables tend to influence demand for postal services: private sector non-farm employment, real retail sales, and real gross domestic investment spending. Of all the macroeconomic measures available, total U.S. employment is the measure that has most closely tracked mail volume growth over time. The outlook for employment growth has changed little in the last ten months. Employment growth is expected to be about 1.7 percent for the fiscal year. This is the same growth rate that was experienced in 2005. Real retail sales, a driver of both advertising mail and packages, are expected to grow 3.4 percent in 2006, slower than in 2005. Real Investment spending, which is correlated with advertising expenditures, is expected to grow 7.0 percent. This growth rate is somewhat inflated by the surge in spending associated with hurricane recovery efforts in the Gulf Coast region.

As always, there are risks embedded in our forecasts. The price of gasoline and the price of crude oil are well above assumed levels. These price increases, and similar increases in other energy sources, have kept inflation well above its core levels for several months. Moreover, increased energy prices may well have an income effect on demand for consumer goods, as energy purchases displace discretionary spending. A slowdown in the housing industry could also feed through to restrain growth in consumer spending and GDP growth.

About 90 percent of the contribution to institutional costs is derived from First-Class Mail and Standard Mail. First-Class Mail continues to be affected by diversion and consolidation. Electronic diversion of hard copy communications like bill payments continues to increase, 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 more of 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 Mail.

Although workshare letter growth was unexpectedly strong in the first half of the year, this growth was more than offset by losses in single-piece First-Class letters. For every piece of workshare letters gained, the Postal Service lost 5.7 pieces of single-piece letters.

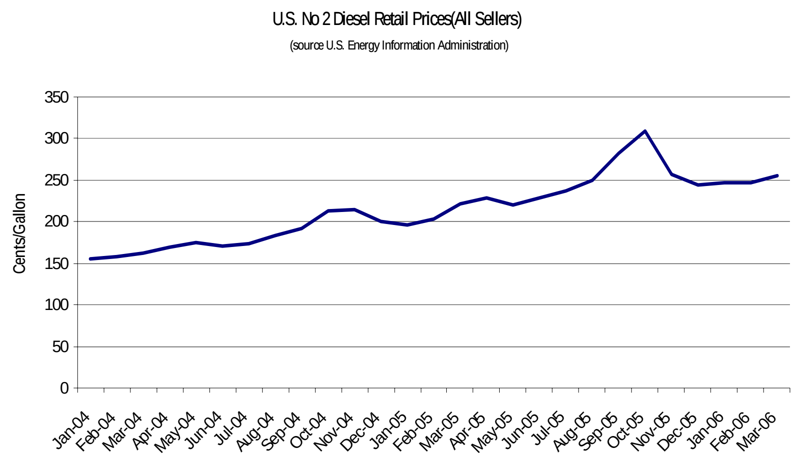
For the first half of the year, Standard Mail volume growth was disappointing. Regular and ECR Standard Mail volume grew only 2.9 percent. On average, the Postal Service needs about 2½ pieces of Standard mail volume for every lost piece of First-Class Mail to maintain its contribution to institutional cost. In the first half of the year, Regular and ECR Standard Mail volume growth was only 2.1 times the loss in First-Class volume growth. Standard Mail continues to provide value in the marketplace since it can be targeted to specific audiences and us a measurable advertising vehicle. Standard Mail demand, however, is far more prone to cyclical variations in the economy than First-Class Mail and tends to be more sensitive to price changes.

Another six to seven percent of the contribution to institutional costs comes from Priority Mail and Express Mail, two highly price sensitive products. Priority Mail volume growth has now been positive for seven consecutive quarters. Quarter 2 was surprisingly strong. Express Mail has grown for sixth consecutive quarters but may yet see volume trends change as a result of the January price increases.

In summary, because the postal delivery network expands each year, revenue growth is needed to support that expansion. Declines in single-piece First-Class Mail volume pose a challenge for Postal Service finances going forward. Single-piece First-Class letters contribute about $9 billion to cover institutional costs annually, about 28 percent of the total contribution. As this mail volume falls, other products must grow in order to replace the contribution. With the exception of workshare First-Class Mail, the mail categories that must grow are much more sensitive to price changes and cyclical economic variations than single-piece First-Class Mail.

Expense Outlook

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, leases and rural carrier equipment maintenance allowances. The effect of fuel inflation also impacts the Consumer Price Index, upon which cost-of-living allowances (COLAs) for our bargaining employees are based. As shown in the Diesel Retail graph, retail prices for diesel fuel, for example, have risen steadily from an average of $1.55 per gallon in January 2004 to a peak of $3.10 per gallon in October 2005. After declining at the end of Quarter 1, prices drifted upward through March. All of these factors have the potential to put significant upward pressure on costs for the remainder of the year and beyond. Since these cost increases cannot be offset by fuel surcharges or immediate price increases, the impact on Net Income could be potentially material.



Pending Legislation

Postal Reform

The Board of Governors sent a letter opposing postal reform legislation in its current form to all United States Senators. Full text of their position on the legislation can be found on our website www.usps.com and is identified in Part II, Item 5, as a press release dated January 24th, 2006.

The administration still opposes the Postal Service's position on several issues, and believes the legislation must be budget-neutral. The full text of the proposed legislation is located at the website http://thomas.loc.gov/.

Free Mailing Privileges for Service-Member Families

Chairman Tom Davis (R-VA) amended H.R. 923 during the committee mark-up to address Postal Service and Department of Defense concerns about the implementation of the original bill. The bill is currently on the calendar for debate.

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. We also have commodity risk for fuel to heat postal 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
Management is responsible for the preparation, integrity, and fair presentation of the financial statements of the Postal Service.

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

No material control deficiencies or weaknesses were identified or reported during the quarter ending March 31, 2006.

Part II. Other Information

Item 1. Legal proceedings

See Note 6, Contingent Liabilities, March 31, 2006 financial statements.

Item 5. Other information

New Accounting Pronouncements
We are in the process of adopting Financial Accounting Standards Board (FASB) Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143” (FIN 47), effective December 31, 2005. We are currently conducting a review to determine our reporting requirements under this pronouncement. At this time, we are unable to determine what impact this pronouncement will have, if any, on our earnings. FIN 47 clarifies that an entity is required to recognize a liability for a legal obligation to perform asset retirement activities when the retirement is conditional on a future event and if the liability’s fair value can be reasonably estimated. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation.

Nominations to the Board of Governors
The President nominated the following individuals to be Governors on the Board of Governors of the United States Postal Service:
Mickey D. Barnett, of New Mexico, for the remainder of a nine-year term expiring December 8, 2013.
Katherine C. Tobin, of New York, for the remainder of a nine-year term expiring December 8, 2012.

Chief Financial Officer
Robert J. Pedersen was named acting chief financial officer, and executive vice president replacing Richard J. Strasser, Jr., who retired on April 3, 2006.

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:

In September 2005, we reached a one-year contract extension with the American Postal Workers Union (APWU, AFL-CIO). The agreement affects approximately 287,000 postal employees represented by the APWU. The contract extension covers the period from November 20, 2005 through November 20, 2006. The agreement provides for a 1.6 percent wage increase effective March 18, 2006 and includes the continuation of the cost-of-living allowances.

The current agreement with the National Association of Letter Carriers (NALC) covering approximately 228,000 mail carriers was negotiated and subsequently ratified in June 2002. The five-year agreement with the NALC is due to expire on November 20, 2006. During 2006, NALC employees will receive regularly scheduled COLA payments in March and September. In addition, in November 2005, employees received a 1.3 percent general wage increase.

National Postal Mail Handlers Union members ratified a two-year contract extension with the United States Postal Service in May 2003. This action resulted 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 for its approximately 64,000 members 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

Press releases can be obtained at http://www.usps.com/communications/news/press/welcome.htm.

May 3, 2006 - News Release #06-031
Postal Service Seeks Price Adjustments

May 3, 2006 - News Release #06-033
Postal Service Highlights Performance Scores

May 3, 2006 - News Release #06-032
Postal Service Proposes New Approach To Shape A More Efficient Future

February 22, 2006 - News Release #06-013
Americans Say U.S. Postal Service Most Trusted Agency

January 24, 2006 - News Release #06-003
Postal Service Opposes Passage of Senate Postal Reform Bill (S. 662)

January 10, 2006 - News Release #06-001
Challenges, Opportunities, and Uncertainties In '06, Says Potter

2005 Cost Revenue Analysis Report

Annually we prepare a detailed analysis of product cost. This analysis is summarized in the Cost Revenue Analysis Report (CRA) and is subjected to an extensive review by our independent auditors. The report for 2005 was completed and issued in April 2006. This report serves as an integral part of our rate making process. The full report is available at http://www.usps.com/financials/cra/welcome.htm.

Total costs increased from $65.9 billion in Fiscal Year 2004 to $68.5 billion in FY2005, up 3.9 percent. Wage rates and benefit cost inflation was 3.7 percent. Workhours increased 0.8 percent, well below the volume increase of 2.7 percent. The volume growth, and the rise in delivery points of 1.6 percent, lead to a workload increase of 1.8 percent.

Overall, unit costs grew about 3.5 percent, with First-Class Mail coming in at an average 3.6 percent increase. Standard Regular was the only class of mail with a decline in unit costs. The modest increases in costs attributable to these classes of mail are indications that letter mail processing continues to be a strength of the Postal Service.

Increases in fuel and other charges helped drive increases above the average unit cost increase for the package and competitive products, such as Express Mail, Priority Mail and Package Services.

COMPARISON OF UNIT COSTS

	FY 2005	FY 2004	Percentage Difference
First-Class Mail:			
Single-Piece Letters................................	$ 0.264	$ 0.252	4.76%
Presort Letters...	0.101	0.095	6.32%
Total Letters..	0.178	0.172	3.49%
Single-Piece Cards..................................	0.208	0.206	0.97%
Presort Cards...	0.070	0.062	12.90%
Total Cards..	0.132	0.129	2.33%
Total First-Class..................................	0.175	0.169	3.55%
Priority Mail...	3.724	3.319	12.20%
Express Mail..	9.155	8.282	10.54%
Periodicals:			
In County..	0.102	0.083	22.89%
Outside County	0.278	0.260	6.92%
Total Periodicals................................	0.263	0.245	7.35%
Standard Mail:			
Enhanced Carrier Route	0.079	0.066	19.70%
Regular	0.125	0.131	-4.58%
Total Standard Mail............................	0.109	0.109	0.00%
Package Services:			
Parcel Post...	2.910	2.643	10.10%
Bound Printed Matter...............................	0.876	0.804	8.96%
Media Mail	2.100	1.855	13.21%
Total Package Services......................	1.757	1.603	9.61%
International Mail	1.671	1.547	8.02%
Total Mail...	$ 0.179	$ 0.173	3.47%