

United States Postal Service

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202-268-2000

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Quarterly Financial Report

**For the Three and Nine Months Ended
June 30, 2006**

August 09, 2006

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Part I. Financial Information

Item 1. Financial Statements

United States Postal Service Statements of Operations

(Dollars in millions)

| | Three months ended June 30, | | Nine months ended June 30, | |
|---|--------------------------------|---------------------|-------------------------------|---------------------|
| | 2006 (unaudited) | 2005 (unaudited) | 2006 (unaudited) | 2005 (unaudited) |
| Operating Revenue | \$ 17,835 | \$ 16,847 | \$ 54,948 | \$ 52,929 |
| Operating Expenses: | | | | |
| Compensation and benefits | 14,078 | 13,436 | 42,052 | 40,583 |
| Transportation | 1,433 | 1,338 | 4,469 | 4,055 |
| Other | 2,267 | 2,248 | 6,728 | 6,429 |
| Total Operating Expenses | 17,778 | 17,022 | 53,249 | 51,067 |
| Income (loss) from Operations | 57 | (175) | 1,699 | 1,862 |
| Interest and investment income | 52 | 28 | 116 | 58 |
| Interest expense on deferred retirement obligations | (28) | (92) | (159) | (201) |
| Other interest expense | - | (1) | (1) | (2) |
| Net Income (loss) | \$ 81 | \$ (240) | \$ 1,655 | \$ 1,717 |

See accompanying notes to the financial statements.

United States Postal Service Balance Sheets - Assets

(Dollars in millions)

| | June 30, 2006 (unaudited) | September 30, 2005 |
|--|---------------------------------|-----------------------|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 3,257 | \$ 930 |
| Receivables: | | |
| Foreign countries | 601 | 590 |
| U.S. government | 200 | 280 |
| Other | 194 | 188 |
| Receivables before allowances | 995 | 1,058 |
| Less allowances | 47 | 50 |
| Total receivables, net | 948 | 1,008 |
| Supplies, advances and prepayments | 169 | 200 |
| Total Current Assets | 4,374 | 2,138 |
| Other Assets, Principally Revenue Forgone Appropriations Receivable | 395 | 376 |
| Property and Equipment, at Cost: | | |
| Buildings | 21,037 | 20,480 |
| Equipment | 19,459 | 18,664 |
| Land | 2,888 | 2,878 |
| Leasehold improvements | 1,221 | 1,172 |
| | 44,605 | 43,194 |
| Less allowances for depreciation and amortization | 23,660 | 22,400 |
| | 20,945 | 20,794 |
| Construction in progress | 1,862 | 1,895 |
| Total Property and Equipment, Net | 22,807 | 22,689 |
| Total Assets | \$ 27,576 | \$ 25,203 |

See accompanying notes to the financial statements.

United States Postal Service
Balance Sheets - Liabilities & Net Capital

(Dollars in millions)

| | June 30, 2006 (unaudited) | September 30, 2005 |
|--|---------------------------------|-------------------------|
| Liabilities and Net Capital | | |
| Current Liabilities: | | |
| Compensation and benefits | \$ 2,911 | \$ 2,852 |
| Estimated prepaid postage | 1,221 | 1,200 |
| Payables and accrued expenses: | | |
| Commercial vendors and accrued expenses | 1,327 | 1,568 |
| Foreign countries | 628 | 688 |
| U.S. government | 68 | 76 |
| Total payables and accrued expenses | <u>2,023</u> | <u>2,332</u> |
| Customer deposit accounts | 1,668 | 1,720 |
| Outstanding postal money orders | 811 | 830 |
| Prepaid box rent and other deferred revenue | 435 | 477 |
| Total Current Liabilities | <u>9,069</u> | <u>9,411</u> |
| Non-Current Liabilities | | |
| Workers' compensation costs | 7,559 | 6,695 |
| Employees' accumulated leave | 2,231 | 2,016 |
| Deferred revenue | 692 | 692 |
| Long-term portion capital lease obligations | 664 | 644 |
| Other | 330 | 369 |
| Total Non-Current Liabilities | <u>11,476</u> | <u>10,416</u> |
| Total Liabilities | 20,545 | 19,827 |
| Net Capital | | |
| Capital contributions of the U.S. government | 3,034 | 3,034 |
| Retained earnings since reorganization | 3,997 | 2,342 |
| Total Net Capital | <u>7,031</u> | <u>5,376</u> |
| Total Liabilities and Net Capital | <u>\$ 27,576</u> | <u>\$ 25,203</u> |

See accompanying notes to the financial statements.

United States Postal Service

Statements of Changes in Net Capital

Nine months ended June 30, 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 | <u>-</u> | <u>1,445</u> | <u>1,445</u> |
| Balance, September 30, 2005 | 3,034 | 2,342 | 5,376 |
| Net Income-Nine months ended June 30, 2006 (unaudited) | <u>-</u> | <u>1,655</u> | <u>1,655</u> |
| Balance, June 30, 2006 (unaudited) | <u><u>\$ 3,034</u></u> | <u><u>\$ 3,997</u></u> | <u><u>\$ 7,031</u></u> |

See accompanying notes to the financial statements.

United States Postal Service

Statements of Cash Flows

(Dollars in millions)

| | Nine months ended June 30, 2006 (unaudited) | Nine months ended June 30, 2005 (unaudited) |
|--|---|---|
| Cash Flows from Operating Activities: | | |
| Net Income | \$ 1,655 | \$ 1,717 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,587 | 1,543 |
| Loss on disposals of property and equipment, net | 8 | 2 |
| Increase in revenue forgone appropriations receivable | (19) | - |
| Increase in workers' compensation liability | 864 | 851 |
| Increase in employees' accumulated leave | 215 | 135 |
| Increase in long-term portion capital lease obligations | 20 | 5 |
| Increase in non-current deferred revenue | - | 484 |
| (Decrease) increase in other non-current liabilities | (39) | 48 |
| Changes in current assets and liabilities: | | |
| Decrease in receivables, net | 60 | 49 |
| Decrease in supplies, advances and prepayments | 31 | 65 |
| Increase in compensation and benefits | 59 | 1,146 |
| Increase in estimated prepaid postage | 21 | 2 |
| Decrease in payables and accrued expenses | (309) | (630) |
| (Decrease) increase in customers deposit accounts | (52) | 37 |
| Decrease in outstanding postal money orders | (19) | (2) |
| (Decrease) increase in prepaid box rent and other deferred revenue | (42) | 5 |
| Net cash provided by operating activities | <u>4,040</u> | <u>5,457</u> |
| Cash Flows from Investing Activities: | | |
| Purchase of property and equipment | (1,730) | (1,554) |
| Proceeds from sale of property and equipment | 17 | 24 |
| Net cash used in investing activities | <u>(1,713)</u> | <u>(1,530)</u> |
| Cash Flows from Financing Activities: | | |
| Payments on debt | - | (1,800) |
| Net cash used in financing activities | <u>-</u> | <u>(1,800)</u> |
| Net increase (decrease) in cash and cash equivalents | 2,327 | 2,127 |
| Cash and cash equivalents at beginning of year | 930 | 877 |
| Cash and cash equivalents at end of period | <u>\$ 3,257</u> | <u>\$ 3,004</u> |
| Supplemental Data | | |
| Cash paid during the year for interest | \$ - | \$ - |

See accompanying notes to the financial statements.

Notes to Financial Statements

Note 1. Basis of Presentation

This interim report reflects the operations of the United States Postal Service for the three and nine months ended June 30, 2006 and 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. Significant items which require managements' assumptions 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 these estimates.

In the opinion of management, the accompanying unaudited financial statements present fairly our financial position as of June 30, 2006 and September 30, 2005 and the results of our operations for the three and nine months ended June 30, 2006 and 2005 and our cash flows for the nine months ended June 30, 2006 and 2005.

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.

Note 2. Retirement Programs

We account for our involvement in the retirement programs of the U.S. Government under the rules of multiemployer plan accounting in accordance with Financial Accounting Standard ("FAS") 87, *Employers' Accounting for Pension Costs*. Therefore, the cost of these benefits is 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 such, we cannot direct the policy that drives the costs, benefits or funding requirements of the federally-sponsored plans.

Retirement contributions for current employees in the third quarter of 2006 were \$1,750 million compared to \$1,693 million in 2005. Year-to-date, contributions were \$5,225 million compared to \$5,086 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 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 of 2006, OPM estimated this liability to be \$3,400 million as of September 30, 2005, a decrease of \$800 million from their June 2005 estimate of \$4,200 million as of September 30, 2004. The resulting September 2006 payment will be \$236 million compared to \$290 million in the prior year.

For the nine months ended June 30, 2006 we have accrued \$177 million for the estimated "supplemental liability" payable on September 30, 2006 compared to \$218 million accrued as of June 30, 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). Just as with our retirement programs, we account for our involvement in FEHBP using multiemployer plan accounting rules in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Therefore, the cost of these benefits is 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 (\$20 million current, \$692 million non-current). For the third quarter we recorded depreciation expense and associated appropriations revenue totaling \$23 million compared to \$11 million in the prior year. Year-to-date, we have recorded \$60 million in revenue compared to \$26 million in 2005. This brings the total revenue recognized from the 2002 appropriation to \$378 million. Other costs of mail security and employee protection, such as maintenance and consumable supplies, are being funded from our revenue and charged as operating expense.

Note 5. Commitments

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

Capital

At June 30, 2006, our financial commitment (resources on order) for approved ongoing capital projects in process is as follows:

| Resources on Order (Dollars in millions) | |
|--|--------------------------|
| Category | June 30, 2006 |
| Mail processing equipment | \$ 1,628 |
| Postal support equipment | 393 |
| Building improvements | 305 |
| Construction and building purchase | 219 |
| Vehicles | 29 |
| Retail equipment | 38 |
| Total Resources on Order | \$ 2,612 |

Rents

At June 30, 2006 our future minimum lease payments for all non-cancelable leases are as follows:

| Future Minimum Lease Payments (Dollars in millions) | | |
|---|----------------------|-----------------|
| Year | June 30, 2006 | |
| | Operating | Capital |
| 2006 | \$ 203 | \$ 26 |
| 2007 | 730 | 103 |
| 2008 | 716 | 101 |
| 2009 | 677 | 99 |
| 2010 | 627 | 95 |
| After 2010 | 5,431 | 658 |
| | <u>\$ 8,384</u> | <u>\$ 1,082</u> |
| Less amount representing interest | | 401 |
| Total capital lease obligations | | 681 |
| Less: short-term portion of capital lease | | 17 |
| Long-term portion of capital lease | | \$ 664 |

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 \$903 million at June 30, 2006 and \$906 million at September 30, 2005. Total accumulated

amortization related to capital leases was \$350 million at June 30, 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 of claims and suits resulting from labor issues, equal employment opportunity issues, environmental issues, property damage claims, injuries on our properties, personal claims, issues arising from our 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 | June 30, | September 30, |
|---|-----------------|----------------------|
| (Dollars in millions) | 2006 | 2005 |
| Labor cases | \$ 266 | \$ 308 |
| Equal employment opportunity cases | 75 | 79 |
| Tort cases | 53 | 49 |
| Environmental cases | 25 | 25 |
| Contractual cases | 12 | 8 |
| Total | <u>\$ 431</u> | <u>\$ 469</u> |

It is the opinion of Management and General Counsel that we have made adequate provision for the probable amounts due under the suits, claims and proceedings referenced in the table. 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.”

Note 7. New Accounting Pronouncements

We are currently conducting a review to determine our reporting requirements under 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. At this time, we are unable to determine what impact this pronouncement will have, if any, on our results of operations or financial condition. 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.

The adoption of the following recent accounting pronouncement did not have a material impact on our results of operations or financial condition:

EITF 05-6, “Determining the Amortization Period for Leasehold Improvements.”

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 managements' 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 and ending September 30.

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 Public Act requires that we offer mailing services as a "fundamental service" to the American public on a "fair and equitable basis."

Our primary product and service lines are First-Class Mail, Standard Mail, Priority Mail, International Mail, Express Mail, Periodical Mail and Package Services. We serve individual and commercial customers throughout the nation. Our services compete for business in the communications, distribution, 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 approximately 37,000 Post Offices, Stations and Branches and a large network of consignees as well as through our website www.usps.com. We deliver to over 145 million addresses through our city, rural, post office box and highway contract delivery services. We conduct our significant operations primarily in the U.S. 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.

Segmentation of marketing, product management, and generation of revenue 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, reporting on volume and revenue presents managements view on the results of operations, and our outlook concerning operations. We do not report revenue from individual customers. No single customer represents more than two percent of our revenue.

Our labor force is primarily represented by the American Postal Workers Union, the National Association of Letter Carriers, the National Postal Mail Handlers Union and the National Rural Letter Carriers Association. Approximately 90 percent of our career employees are covered by collective bargaining agreements. By law, 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, we make disclosures not required by SEC reporting rules through the publication of certain reports that we either must make, or choose to make public. These additional disclosures on our organization and finances, including our Cost and Revenue Analysis reports, Integrated Financial Plan, and Revenue, Pieces, and Weight reports, may be found on our website, at www.usps.com/financials.

Results of Operations

Operating Revenue for the third 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 third quarter was \$17,835 million, compared to \$16,847 million in the corresponding quarter last year. This increase of \$988 million, or 5.9 percent, was accompanied by a volume increase of 1,178 million pieces. The largest component of the revenue increase came from First-Class Mail which experienced a \$504 million increase. The largest increase in volume came from Standard Mail which increased 697 million pieces.

Operating revenue in the first nine months of 2006 was \$54,948 million, compared to \$52,929 million for the same period last year. This revenue increase of \$2,019 million, or 3.8 percent, was accompanied by a volume increase of 1,494 million pieces. The largest component of the revenue and volume increase came from Standard Mail which experienced a \$693 million increase in revenue and an increase in volume of 1,476 million pieces.

For the third quarter, operating expenses increased \$756 million, or 4.4 percent. Compensation and benefits expense, which increased \$642 million, contributed to most of the increase over the same period last year. Transportation expenses, which increased \$95 million, driven by higher jet fuel, diesel, and gasoline prices, contributed significantly to expense growth. Supplies and services accounted for \$46 million of the increase as well.

Year-to-date, operating expenses increased \$2,182 million, or 4.3 percent. Compensation and benefits expense, which increased \$1,469 million, contributed the largest portion of the increase over the same period last year. Transportation expenses, which increased \$414 million for the reasons mentioned above, also contributed significantly to expense growth. Other expenses and supplies and services increased \$146 and \$109 million, respectively.

Net income of \$81 million for the third quarter increased \$321 million when compared to the same quarter last year.

Year-to-date, net income was \$1,655 million, a decrease of \$62 million from the comparable period last year.

Summary of Interim Financial Results

| Three Months Ended June 30, | | | Financial Results (Dollars in millions) | Nine Months Ended June 30, | | |
|-----------------------------|-----------------|---------|---|----------------------------|-----------------|---------|
| 2006 | 2005 | %Change | | 2006 | 2005 | %Change |
| \$ 17,835 | \$ 16,847 | 5.9% | Operating Revenue | \$ 54,948 | \$ 52,929 | 3.8% |
| | | | Operating Expense | | | |
| 14,078 | 13,436 | 4.8% | Compensation and benefits | 42,052 | 40,583 | 3.6% |
| 1,433 | 1,338 | 7.1% | Transportation | 4,469 | 4,055 | 10.2% |
| 649 | 603 | 7.6% | Supplies and services | 1,835 | 1,726 | 6.3% |
| 513 | 532 | -3.6% | Depreciation and amortization | 1,587 | 1,543 | 2.9% |
| 1,105 | 1,113 | -0.7% | Other expenses | 3,306 | 3,160 | 4.6% |
| <u>17,778</u> | <u>17,022</u> | 4.4% | Total Operating Expense | <u>53,249</u> | <u>51,067</u> | 4.3% |
| 57 | (175) | NM | Income (loss) from Operations | 1,699 | 1,862 | NM |
| 52 | 28 | 85.7% | Interest and investment income | 116 | 58 | 100.0% |
| (28) | (92) | -69.6% | Interest on deferred retirement obligations | (159) | (201) | -20.9% |
| - | (1) | NM | Interest expense on borrowings | (1) | (2) | NM |
| <u>\$ 81</u> | <u>\$ (240)</u> | NM | Net Income (loss) | <u>\$ 1,655</u> | <u>\$ 1,717</u> | NM |

Note: Percentages are calculated based on unrounded numbers.
 NM: Not Meaningful to present as %difference

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

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 of \$3 billion, we increased most postal rates and fees by an average 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 \$3 billion as restricted cash on the balance sheet, not as an expense, however, management must operate as if the escrow is an expense.

The table below reflects what our financial statements would look like if the escrow were reported as an expense. We have assumed an allocation amount of \$750 million quarterly, \$2,250 million for nine months. Using those assumptions, we would have a net loss of \$669 million for the three months ended June 30, 2006 and a net loss of \$595 million year-to-date.

| | Three Months ended June 30, 2006 | Nine Months ended June 30, 2006 |
|--------------------------------|-------------------------------------|------------------------------------|
| Total Revenue | \$ 17,887 | \$ 55,064 |
| Total Expense | 17,806 | 53,409 |
| Net Income (GAAP Basis) | 81 | 1,655 |
| Escrow Allocation | 750 | 2,250 |
| Net Loss | \$ (669) | \$ (595) |

Operating Revenue and Volume Analysis

Volume Analysis

Volume growth rates have been impacted by the across the board rate increase of January 2006. Analysis of the impact on each category follows:

| Volume by Class of Mail | | | | | | |
|--------------------------------|-----------------|----------|---------------------------------------|---------------------------|------------------|----------|
| Three Months Ended June 30 | | | Class of Mail (Pieces in millions) | Nine Months Ended June 30 | | |
| 2006 | 2005 | % change | | 2006 | 2005 | % change |
| 23,917.0 | 23,631.4 | 1.2% | First-Class Mail | 74,396.5 | 74,716.2 | -0.4% |
| 24,825.9 | 24,129.4 | 2.9% | Standard Mail | 76,887.2 | 75,411.2 | 2.0% |
| 2,273.8 | 2,285.3 | -0.5% | Periodicals | 6,865.0 | 6,915.9 | -0.7% |
| 255.8 | 265.3 | -3.6% | Package Services | 880.8 | 868.3 | 1.4% |
| 220.6 | 217.6 | 1.4% | Priority Mail | 710.5 | 676.1 | 5.1% |
| 14.3 | 14.4 | -0.9% | Express Mail | 42.6 | 41.7 | 2.2% |
| 205.2 | 205.6 | -0.2% | International | 662.7 | 655.7 | 1.1% |
| 387.4 | 173.2 | 123.6% | Other | 872.6 | 538.8 | 61.9% |
| <u>52,100.0</u> | <u>50,922.2</u> | 2.3% | Total Mail Volume | <u>161,317.9</u> | <u>159,823.9</u> | 0.9% |

Note: Percentages are calculated based on unrounded numbers.

First-Class Mail volume increased 286 million pieces, or 1.2 percent, in the third quarter. First-Class Mail, single-piece letter volume declined 1.3 percent in the third quarter. This decline was more than offset by a 3.8 percent increase in workshare letters. Single-piece postcard volume fell 6.7 percent, but this decline was also more than offset by an 8 percent increase in workshare postcards. The single-piece volume reduction was moderate compared to recent quarterly declines. Growth in workshare letters was the second strongest quarterly performance in the last four years.

Year-to-date, First-Class Mail volume declined 320 million pieces, or 0.4 percent, as declines in single-piece letters of 2.7 percent, and postcards of 8.4 percent, were larger in absolute terms than growth in workshare letters of 1.4 percent and postcards of 8.4 percent.

Standard Mail volume grew 697 million pieces, or 2.9 percent, in the third quarter. Enhanced Carrier Route (ECR) volume grew 8 percent, the strongest increase in ten years. Regular Standard Mail volume grew 0.7 percent this quarter. Nonprofit ECR volume grew 3.5 percent in the third quarter but this growth was offset by a decline of 1 percent in Regular Nonprofit volume.

On a year-to-date basis, Standard Mail volume grew 1,476 million pieces, or 2 percent. ECR volume grew 4.5 percent while Regular Standard volume grew more slowly at 2.2 percent. Regular Nonprofit volume declined 0.6 percent, and Nonprofit ECR declined 16.7 percent being adversely affected by weaker volume in a non-election year.

Periodical Mail volume fell 12 million pieces, or 0.5 percent, in the third quarter. The volume decline on a year-to-date basis was 31 million pieces, or 0.7 percent. These declines were consistent with long term trends in the Periodicals industry.

Package Services volume fell 10 million pieces, or 3.6 percent, in the third quarter. A volume decline of 10.9 percent in Parcel Post was the largest contributor to the decline. The Parcel Select component of this subclass may have been adversely affected by rising fuel prices causing three major parcel consolidators to cease operations in the last six months. Media Mail volume declined 2 million pieces, 5.7 percent, however Bound Printed Matter volume grew by 2 million pieces, or 1.6 percent.

For the first nine months of the year, Package Services volume was up 13 million pieces, or 1.4 percent. Bound Printed Matter increased 7.8 percent and Library Mail increased 7 percent contributing to the increase, however, Parcel Post declined 6.1 percent and Media Mail 1.5 percent and offsetting some of the increase.

Priority Mail volume growth slowed to 3 million pieces, or 1.4 percent, in the third quarter. This is the eighth consecutive quarter of positive growth in Priority Mail volume.

On a year-to-date basis Priority Mail volume grew 34 million pieces, or 5.1 percent. The success of Priority Mail, as mentioned in our second quarter Financial Report, is tied to four factors. 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 increase in our competitors' surcharges for fuel, residential delivery, and delivery in rural areas make Priority Mail an increasingly cost effective choice, especially for small-volume users of Priority Mail, who generally cannot negotiate discounts or other pricing concessions with private sector competitors.

Express Mail volume was flat for the quarter. Year-to-date, Express Mail volume grew 1 million pieces, or 2.2 percent. Like Priority Mail, Express Mail had benefited from continued rate stability, and the impact of surcharges imposed by private sector competitors, as well as website access on www.usps.com.

International Mail originating in the United States remained flat in the third quarter but increased 7 million pieces, or 1.1 percent, in the first nine months of 2006.

"Other" volume, in the table, includes mail sent by the U.S. Postal Service and Free Mail for the Blind and Handicapped. Volume from "Other" mail grew 214 million pieces, or 123.6 percent in the third quarter mainly as a result of a continuing Postal Service promotional campaign. For the first nine months of the year, "Other" mail volume grew 334 million pieces, or 61.9 percent.

Revenue Analysis

Rates for most of our 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 increase, while Parcel Post, Media and Library mail received considerably higher than average rate increases of 7.1 percent, 12.7 percent and 12.6 percent respectively. Analysis of the impact on each category follows:

| Revenue by Class of Mail | | | | | | | |
|-----------------------------|------------------|----------|--|----------------------------|------------------|----------|--|
| Three Months Ended June 30, | | | Class of Mail (Dollars in millions) | Nine Months Ended June 30, | | | |
| 2006 | 2005 | % change | | 2006 | 2005 | % change | |
| \$ 9,188 | \$ 8,684 | 5.8% | First-Class Mail | \$ 28,140 | \$ 27,491 | 2.4% | |
| 4,863 | 4,521 | 7.6% | Standard Mail | 14,866 | 14,173 | 4.9% | |
| 560 | 539 | 3.9% | Periodical Mail | 1,674 | 1,643 | 1.9% | |
| 514 | 492 | 4.6% | Package Services | 1,717 | 1,688 | 1.7% | |
| 1,206 | 1,118 | 7.9% | Priority Mail | 3,871 | 3,541 | 9.3% | |
| 235 | 224 | 5.0% | Express Mail | 697 | 657 | 6.2% | |
| 428 | 438 | -2.2% | International * | 1,444 | 1,369 | 5.5% | |
| 841 | 831 | 1.0% | Other | 2,539 | 2,367 | 7.3% | |
| <u>\$ 17,835</u> | <u>\$ 16,847</u> | 5.9% | Total Operating | <u>\$ 54,948</u> | <u>\$ 52,929</u> | 3.8% | |

Note: Percentages are calculated based on unrounded numbers.
* International does not include revenue from in-bound postage originating at foreign postal facilities.

First-Class Mail revenue increased \$504 million, or 5.8 percent, in the third quarter which is slightly greater than the 5.4 percent increase in rates because of the volume increase discussed earlier.

On a year-to-date basis, First-Class revenue increased \$649 million, or 2.4 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 increasing.

Standard Mail revenue grew \$342 million, or 7.6 percent, in the third quarter. The rate increases for Standard Mail averaged out to approximately 5 percent for commercial Standard and 5.7 percent for Nonprofit Standard.

For the first nine months of the year, Standard Mail revenue grew \$693 million, or 4.9 percent. This, as stated above, was driven by the rate increase.

A declining circulation base for newspapers and magazines limited Periodical Mail revenue growth to \$21 million, or 3.9 percent, in the third quarter and \$31 million, or 1.9 percent, in the first nine months of the year.

Package Services revenue increased \$22 million, or 4.6 percent, in the third quarter. Parcel Post accounted for just over 53 percent of Package Service revenue. For the third quarter, Parcel Post increased 2.2 percent following a 7.1 percent rate increase. Bound Printed Matter grew 7.2 percent, following a 5.5 percent rate increase. Media Mail grew 6.8 percent this quarter. This growth is largely attributable to the 12.7 percent rate increase. Library Mail revenue, which constitutes less than 2 percent of Package Services revenue, grew 22.6 percent and accounted for 4.5 percent of the increase.

For the first nine months of the year, Package Services revenue increased \$29 million or 1.7 percent. Parcel Post accounted for almost 55 percent of Package Service revenue during this period but declined 3 percent. Bound Printed Matter grew 8.1 percent, Media Mail grew 7.1 percent, and Library Mail increased 15.7 percent.

Priority Mail revenue grew \$88 million, or 7.9 percent, in the third quarter. The average weight also increased 5.4 percent. This growth trend is attributed to Priority Mail's increasing value in the marketplace, the January rate increase, and the continued increase in average weight per piece.

Year-to-date, Priority Mail revenue increased \$330 million, or 9.3 percent. The average weight of Priority Mail grew 8.2 percent, in the first nine months of the fiscal year compared to the first nine months of 2005.

Express Mail revenue grew \$11 million, or 5 percent, in the third quarter compared to the same period last year. Like Priority Mail, Express Mail is also experiencing weight increases, which averaged 2.7 percent.

Express Mail revenue grew \$40 million, or 6.2 percent, in the first nine months of the year. The average weight of express mail packages increased 5.4 percent for the same period.

Revenue from International Mail fell \$9 million, or 2.2 percent, in the third quarter, but increased \$75 million, or 5.5 percent, year to date. International revenue includes revenue from foreign postal transactions not included in volume estimates.

“Other” revenue, which includes special services, increased \$9 million or 1 percent in the third quarter. Contributing to this increase was Passport acceptance services which increased \$9 million and Delivery Receipt Services which also increased \$9 million. Declines in revenue from Registered, Collect on Delivery (COD) and other services offset almost half these gains.

For the first nine months of the year “Other” revenue increased \$172 million or 7.3 percent. The principal components of the revenue increase were passport acceptance revenue of \$41 million, Certified Mail revenue of \$25 million and Delivery Receipt Services revenue of \$29 million.

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

Operating Expenses

Compensation and Benefits and Workhour Analysis

Total compensation and benefits for the third quarter was \$14,078 million, or 4.8 percent, higher than the prior year amount of \$13,436 million. This increase of \$642 million was driven by salary and benefit increases of \$549 million, which included an increase in wages of \$439 million, retirement contributions of \$57 million and \$53 million in employee health benefits. Retiree health benefits increased \$35 million, workers compensation costs increased \$41 million, and other personnel costs increased \$17 million.

Year-to-date total compensation and benefit costs are \$42,052 million, or 3.6 percent, higher than the prior year amount of \$40,583 million. This increase of \$1,469 was driven by salary and benefits increases of \$1,285 million. Included in this amount, were increases of \$933 million for wages, \$139 million for retirement contributions and \$213 million for employee health benefits. Retiree health benefits increased \$114 million, workers compensation costs increased \$39 million and other personnel costs increased \$31 million.

Overall benefits, which include health benefits for current and retired personnel as well as workers' compensation and retirement costs, constituted over 27.8 percent of our total personnel compensation expenses in the third quarter and 27.7 percent year-to-date.

Wages

Wages grew in the third quarter by \$439 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 pay increase. In addition, almost all bargaining unit employees received annualized cost of living increases in September, 2005 and March 2006. The September, 2005 COLA of \$728 per eligible employee was the largest COLA since May 1980. The March, 2006 COLA was \$457 per eligible employee. The September and March COLAs were responsible for \$100 million of the \$439 million increase in wages. Included in the wage growth is the impact of an 11.6 percent growth in overtime hours in the third quarter. This contributed \$125 million to the total wage increase.

Wages grew in the first nine months of 2006 by \$933 million compared to the same period last year. This, as discussed above, contains significant COLA adjustments. The September 2005 and March 2006 COLAs discussed above were responsible for \$158 million of the \$933 million increase in wages. Also included in the wage growth is the impact of an 8.3 percent growth in overtime hours contributing \$262 million to the total wage increase.

Workhours

A change in workhours is usually created by a change in workload, a change in productivity, or both. The two major workload factors that impact our operations are changes in mail volume and changes in possible deliveries. 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 of half of the year to the prior periods in question.

In our third quarter, mail volume increased by 1,178 million pieces, or 2.3 percent, as compared to the same quarter last year. Total workhour usage declined 1.6 million hours, or 0.5 percent, from the comparable period last year.

Year-to-date, mail volume increased by 1,494 million pieces, or 0.9 percent, as compared to the same period last year. Total workhour usage declined 2.3 million hours, or 0.2 percent, from the comparable period last year.

Third Quarter Workhours

Workhours in the mail processing function decreased by 0.7 million workhours 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 contributed to 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 4 million workhours with unchanged productivity. The reduced workhour utilization is therefore due to an increased productivity level of 1 percent in the third quarter. Route inspections, which began in the second quarter, will provide a basis for capturing additional savings in the future as city delivery routes are realigned or eliminated.

Workhours in administrative functions were 1.9 million less than the same quarter last year. This is due to a continued effort to reduce administrative costs.

Listed below are the workhours, salaries and benefits by function for the third quarter of 2006 compared with the same period last year:

Compensation , Benefits and Workhour Analysis

| Workhours Three Months Ended June 30, (In thousands) | | | Salaries and Benefits Three Months Ended June 30, (Dollars in millions) | | | |
|---|----------------|----------|--|-----------------|----------|-------|
| 2006 | 2005 | % Change | 2006 | 2005 | % Change | |
| Salaries and Benefits by Function | | | | | | |
| Operations | | | | | | |
| 117,672 | 117,722 | 0.0% | \$ 4,361 | \$ 4,173 | 4.5% | |
| 80,766 | 81,482 | -0.9% | 2,907 | 2,814 | 3.3% | |
| 61,238 | 61,437 * | -0.3% | 2,100 | 2,003 | 4.8% | |
| 47,139 | 46,080 | 2.3% | 1,402 | 1,320 | 6.2% | |
| 20,452 | 20,371 | 0.4% | 802 | 760 | 5.5% | |
| 8,052 | 7,974 | 1.0% | 317 | 300 | 5.7% | |
| 2,555 | 2,531 | 0.9% | 118 | 112 | 5.4% | |
| Headquarter, Area & District Management, Postmasters, Administration and Other | | | | | | |
| 25,304 | 27,229 * | -7.1% | 1,250 | 1,226 | 2.0% | |
| <u>363,178</u> | <u>364,826</u> | -0.5% | <u>13,257</u> | <u>12,708</u> | 4.3% | |
| Other Compensation | | | | | | |
| Not Applicable | | | Workers' Compensation | 299 | 258 | 15.9% |
| | | | Retiree Health Benefits | 422 | 387 | 9.0% |
| | | | Other | 100 | 83 | 20.5% |
| <u>363,178</u> | <u>364,826</u> | -0.5% | <u>\$14,078</u> | <u>\$13,436</u> | 4.8% | |

Note: Percentages are calculated based on unrounded numbers

* 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

Year-to-Date Workhours

In the first nine months of 2006, workhours in the mail processing function decreased by 2.1 million workhours due to cost savings programs and improvements in operational efficiencies. Delivery growth resulted in increased workload in the delivery network of 4.4 million hours over the first nine months of last year. As in the third quarter, productivity increases of 0.5 percent reduced workhour utilization in the first nine months of 2006.

Again, due to a continued effort to reduce costs, workhours in administrative functions are 4.1 million less than the same period last year.

Listed below are workhours, salaries and benefits by function for the first nine months of 2006 compared with the same period last year:

Compensation , Benefits and Workhour Analysis

| Workhours Nine Months Ended June 30, (In thousands) | | | Salaries and Benefits Nine Months Ended June 30, (Dollars in millions) | | | |
|--|------------------|----------|---|-----------------|-----------------|----------|
| 2006 | 2005 | % Change | | 2006 | 2005 | % Change |
| | | | Salaries and Benefits by Function | | | |
| | | | Operations | | | |
| 352,069 | 353,791 | -0.5% | -City Delivery | \$12,979 | \$12,554 | 3.4% |
| 252,963 | 255,033 | -0.8% | -Mail Processing | 8,891 | 8,679 | 2.4% |
| 186,771 | 186,681 * | 0.0% | -Customer Services, Retail & Sales | 6,299 | 6,062 | 3.9% |
| 138,417 | 133,641 | 3.6% | -Rural Delivery | 4,098 | 3,815 | 7.4% |
| 61,144 | 60,913 | 0.4% | -Plant & Equip Maintenance | 2,361 | 2,262 | 4.4% |
| 24,186 | 24,024 | 0.7% | -Vehicles Services | 938 | 898 | 4.5% |
| 7,462 | 7,179 | 3.9% | -Operations Support | 342 | 316 | 8.2% |
| | | | Headquarter, Area & District Management, Postmasters, Administration and Other | | | |
| 76,327 | 80,404 * | -5.1% | | 3,707 | 3,744 | -1.0% |
| <u>1,099,339</u> | <u>1,101,666</u> | -0.2% | Subtotal | <u>39,615</u> | <u>38,330</u> | 3.4% |
| | | | Other Compensation | | | |
| Not Applicable | | | Workers' Compensation | 897 | 858 | 4.5% |
| | | | Retiree Health Benefits | 1,236 | 1,122 | 10.2% |
| | | | Other | 304 | 273 | 11.4% |
| <u>1,099,339</u> | <u>1,101,666</u> | -0.2% | Total | <u>\$42,052</u> | <u>\$40,583</u> | 3.6% |

Note: Percentages are calculated based on unrounded numbers

* 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

Other Compensation

Workers' compensation costs of \$299 million represented approximately 2.1 percent of compensation and benefits expense in the third quarter, compared to \$258 million, or 1.9 percent, for the comparable period last year. Year-to-date, these costs of \$897 million and \$858 million, respectively, were flat at 2.1 percent of compensation and benefits expenses for 2006 and 2005. 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, age of the injured employee, 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. Through the current Department of Labor chargeback year (July 1, 2005-June 30, 2006), we experienced a 2.4 percent decrease in the number of paid medical claims and a 0.4 percent decline in the number of paid compensation claims. However, average cost per claim increased for both medical and compensation claims by 8.8 and 5.5 percent, respectively, causing worker's compensation expenses to increase for both the quarter and the year.

Retiree health benefit costs were \$422 million in the third quarter, compared to \$387 million in the corresponding quarter last year, an increase of 9 percent. See Note 3 for a full description of the retiree health benefits program. The major drivers of this expense are the number of retirees receiving benefits and inflation in premium costs. As of June 30, 2006, we had approximately 447,000 participants on the rolls, an increase of about 5,000 over the prior year. Retiree health benefits represent 3 percent of compensation and benefits.

Retiree health benefit costs were \$1,236 million, year-to-date, compared to \$1,122 million in the corresponding period last year, a 10.2 percent increase. Year-to-date, retiree health benefits are 2.9 percent of compensation and benefits.

Employee Complement

Employee complement increased by 1,260 during the quarter but, decreased 7,249 year-to-date. The total number of career employees at the end of the quarter was 697,467. This represents a reduction of 5,496 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 (Dual), 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 \$1,750 million for current employees, which are included in compensation and benefits expense, increased \$57 million compared to the same period last year. Year-to-date, retirement expenses of \$5,225 million increased \$139 million. These expenses were 9.8 percent of our total expenses for the quarter and the year.

Transportation

Transportation expenses were \$1,433 million, an increase of \$95 million, or 7.1 percent, for the quarter. Year-to-date, transportation costs were \$4,469 million, an increase of \$414 million, or 10.2 percent. The major components of other transportation expenses for the three and nine months ending June 30, 2006 and 2005 are as follows:

| Transportation expenses | | | | | | |
|--------------------------------|-----------------|-----------------|-------------------------------|--------------------------|-----------------|-----------------|
| Three Months Ended | | | (Dollars in millions) | Nine Months Ended | | |
| June 30, | | | | June 30, | | |
| 2006 | 2005 | % Change | | 2006 | 2005 | % Change |
| \$ 658 | \$ 605 | 8.8% | Air transportation | \$ 2,044 | \$ 1,832 | 11.6% |
| 703 | 649 | 8.3% | Highway transportation | 2,218 | 1,977 | 12.2% |
| 72 | 84 | -14.3% | Other transportation | 207 | 246 | -15.9% |
| <u>\$ 1,433</u> | <u>\$ 1,338</u> | 7.1% | Total | <u>\$ 4,469</u> | <u>\$ 4,055</u> | 10.2% |

Air transportation expenses of \$658 million increased \$53 million, or 8.8 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 third quarter, jet fuel costs increased 31 percent from the same quarter last year, causing air transportation costs to increase approximately \$23 million. Increased Air Mail volume on the dedicated network accounted for \$24 million in additional costs.

Year-to-date, air transportation expenses of \$2,044 million increased \$212 million, or 11.6 percent. This is primarily attributed to increased fuel charges as well as contractual rate increases for our dedicated air carrier. Increasing jet fuel costs resulted in \$99 million of additional air transportation costs. Air mail volume on the dedicated network accounted for an additional \$55 million in costs and contractual rate increases accounted for about \$42 million of increased air transportation costs.

Highway transportation expenses increased by \$54 million to \$703 million, or 8.3 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 third quarter, retail gasoline prices increased an average of 25.7 percent from the same period last year. This resulted in increased fuel costs for highway contract operations of approximately \$27 million for the third quarter. Additional miles driven accounted for \$16 million in increased 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 \$13 million of additional costs in the third quarter.

Year-to-date, highway transportation expenses of \$2,218 million increased by \$241 million, or 12.2 percent, over last year. The increase was driven primarily by higher fuel prices and contractual rate increases for drivers. Gasoline prices, again, caused increased fuel costs for highway contract operations of approximately \$107 million. Due to network growth, additional miles driven accounted for an additional \$43 million in fuel charges. Contract payments to drivers resulted in additional costs of \$42 million year-to-date.

Other transportation expenses decreased \$12 million dollars in the third quarter and \$39 million, year-to-date, 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 \$649 million were \$46 million, or 7.6 percent, higher in the third quarter than last year's comparable period. Expenses for professional and other services increased \$31 million compared to the same quarter last year due in part to new programs such as Bio-Detection Systems Logistics (BDS) to support equipment purchased in the aftermath of the Anthrax attack, increased credit/debit card processing charges as well as increases in other programs. Supplies accounted for an additional \$23 million while equipment rental increased by \$3 million. Consulting fees declined by \$9 million.

Year-to-date, supplies and services expenses of \$1,835 million increased \$109 million, or 6.3 percent, compared to last year's comparable period. Expenses for professional and other services increased approximately \$107 million compared to the same period last year primarily due to increased credit/debit card processing charges as well as new programs such as BDS, as referenced above. Increases in supplies of approximately of \$36 million and equipment rental charges of \$12 million were offset by declines in consulting fees of \$33 million and advertising of \$15 million.

Depreciation and Amortization

Depreciation expenses of \$513 million were \$19 million less than last year's comparable quarter. This was primarily due to declines in depreciation on retail equipment which became fully depreciated.

Depreciation expenses, year-to-date, of \$1,587 million were \$44 million more than last year's comparable period. Depreciation increased on equipment \$31 million, vehicles \$14 million, and buildings \$13 million, while amortization on capital leases decreased \$14 million.

Other operating expenses

The major components of other operating expenses for the three and nine months ending June 30, 2006 and 2005 are as follows:

| Other operating expenses | | | | | | |
|---------------------------------|----------------|-----------------|--|--------------------------|----------------|-----------------|
| Three Months Ended | | | (Dollars in millions) | Nine Months Ended | | |
| June 30, | | | | June 30, | | |
| 2006 | 2005 | % Change | | 2006 | 2005 | % Change |
| \$ 406 | \$ 379 | 7.1% | Rent & utilities | \$1,259 | \$1,192 | 5.6% |
| 180 | 143 | 25.9% | Vehicle maintenance services | 518 | 426 | 21.6% |
| 167 | 162 | 3.1% | Information technology and communications | 451 | 420 | 7.4% |
| 110 | 126 | -12.7% | Rural carrier equipment maintenance allowances | 347 | 323 | 7.4% |
| 242 | 303 | -20.1% | Other | 731 | 799 | -8.5% |
| <u>\$1,105</u> | <u>\$1,113</u> | -0.7% | Total | <u>\$3,306</u> | <u>\$3,160</u> | 4.6% |

Other operating expenses of \$1,105 million were \$8 million, or 0.7 percent, lower than last year's comparable quarter. This decline was primarily attributable to decreased charges associated with our contingent liabilities, which is part of other expenses, for such cases as labor disputes, tort issues, etc. of \$62 million. Otherwise, this line item would have increased for the quarter. Charges for rent and utilities increased \$27 million with electricity of \$16 million being the major component. Vehicle maintenance services (VMS) increased \$37 million with fuel charges of \$24 million being the main driver of this increase. Rural carrier equipment maintenance allowances (RCEMA) declined \$16 million primarily due to one less pay date in the current quarter compared to the same period last year.

Year-to-date, other expenses of \$3,306 million were up \$146 million, or 4.6 percent, higher than last year's comparable period. VMS accounted for the largest increase at \$92 million as bulk fuel costs rose. Rent and utilities increased \$67 million, driven by electricity and natural gas costs. IT and communication expense increased \$31 million primarily for upgraded communication networks. RCEMA increased \$24 million due to increased fuel charges impacting the equipment maintenance allowances paid to rural carriers. These increases were partially mitigated by declines in contingent liabilities of \$40 million, and bad debt expense of \$15 million.

Interest Expense

Interest expense of \$28 million was \$65 million lower than last year's comparable quarter. Interest expense of \$160 million year-to-date was \$43 million less than last year's comparable period. \$159 million of the interest expense year-to-date and the entire decrease in interest expense is due to the decreased CSRS supplemental retirement obligation. This obligation was calculated by the Office of Personnel Management in June 2006.

Productivity

Total Factor Productivity (TFP) measures the change in the relationship between outputs, or workload, and all the resources used in producing these outputs. The main outputs are mail 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 third quarter, TFP related workload increased by 1.5 percent, with resource usage increasing 0.5 percent, yielding a 1 percent increase in TFP versus the same period last year. The workload increase was driven primarily by mail volume increase which contributed 1.2 percentage points to the workload growth. Continuing delivery network growth contributed an additional 1 percentage point to workload growth, while declines in miscellaneous services offset these by 0.2 percentage points. The 0.5 percent growth in resource usage was driven by increases in materials and capital usage which combined contributed 0.9 percentage points to the growth in resources usage. These increases were offset by 0.4 percentage point reduction in labor usage.

For the first three quarters of 2006, workload increased by 1.2 percent, while resource usage increased 0.6 percent. This yielded a 0.5 percent increase in TFP. This productivity increase is equivalent to an expense reduction of \$292 million. The 1.2 percent workload increase was driven primarily by mail volume growth which contributed 0.6 percentage points to workload growth. The continuing delivery network growth contributed 0.5 percentage points to workload growth and miscellaneous services contributed the remaining 0.1 percentage point. The 0.6 percent increase in resource usage was driven by increases in materials and capital usage which combined contributed 0.9 percentage points to the growth in resources usage. These increases were offset by 0.3 percentage points reduction in labor usage.

Financial Condition

Debt and Liquidity

As of June 30, 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 \$3,257 million, \$2,327 million higher than September 30, 2005, and \$253 million higher than the end of June 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 from operations increased our cash and cash equivalents balance.

For the first nine months of 2006, net cash provided by operating activities was \$1,417 million lower than the same period last year, while net cash used in investing activities (capital outlays) was \$183 million higher.

We do not anticipate any borrowing until the end of the current year. In September, we anticipate approximately \$1.1 billion in lump sum payments for workers' compensation and retirement liabilities. Additionally, we do not expect cash flow from operations, year-to-date, to supply enough cash to fund both the escrow requirement, estimated at \$3 billion, and capital investments. Consequently, we anticipate increasing debt by almost \$2 billion in September.

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 year-to-date through the third quarter were \$952 million compared to \$1,158 million in 2005.

During the third quarter, the Board of Governors approved funding for three projects, the Automated Flat Sorting Machine (AFSM 100) Automatic Induction Phase 2; Additional Delivery Bar Code Sorter (DBCS) Equipment, and the Oklahoma City, Oklahoma, Plant and Vehicle Maintenance Facility. Phase 2 of the AFSM Automatic Induction program will fund the purchase and installation of 148 Automatic Induction systems in 83 mail processing facilities nationwide. The AFSM-AI is a modification to an existing AFSM 100 that replaces manual flat mail preparation activities with a mechanized preparation, transport, and loading system. The additional DBCS machines include 211 new DBCS VI machines and 797 stacker modules for existing Phase II-V DBCS machines. The additional equipment will increase the amount of letter mail processed in automated operations and provide labor savings in manual sorting operations. The approval of the Oklahoma City facility will alleviate space deficiencies and enable the consolidation of split operations, thereby increasing operating windows, reducing transportation and labor costs, and increasing service and productivity.

Below is the table representing Capital Commitments, Expenditures, and Resources on Order, summarizes 2006 activity year-to-date compared to last year:

Capital Commitments, Expenditures, and Resources on Order

| Capital Investments (Dollars in millions) | Commitments ⁽¹⁾ | | Cash Outlays | | Resources on Order ⁽²⁾ | |
|--|----------------------------|-----------------|----------------------|-----------------|-----------------------------------|-----------------|
| | Year to Date Through | | Year to Date Through | | June 30, | |
| | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| Construction and building purchase | \$ 208 | \$ 152 | \$ 128 | \$ 163 | \$ 219 | \$ 178 |
| Building improvements | 295 | 208 | 395 | 311 | 305 | 272 |
| Mail processing equipment | 332 | 243 | 721 | 514 | 1,628 | 1,305 |
| Vehicles | 16 | 32 | 190 | 129 | 29 | 24 |
| Retail equipment | - | 1 | 1 | 55 | 38 | 41 |
| Postal support equipment | 101 | 522 | 295 | 382 | 393 | 555 |
| Total | \$ 952 | \$ 1,158 | \$ 1,730 | \$ 1,554 | \$ 2,612 | \$ 2,375 |

(1) Capital Commitment - Binding agreements entered into by us 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. For the third quarter EXFC overnight scores have rebounded from their low of 94 percent in the first quarter of 2006. However, the score of 95 percent on time delivery in the third quarter is one percentage point below the 96 percent on time delivery achieved in same period last year. EXFC two-day scores are up one percentage point to 91 percent in the third quarter of 2006 compared to SPLY, while three-day scores of 91 percent are down one percentage point compared to SPLY.

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. After drops from previous quarters in the current year, customer satisfaction ratings have risen from a low of 91 percent in the second quarter to 92 percent in the third quarter. Overall satisfaction in the current quarter however, remains one point below the prior year's score of 93 percent.

Rate and Classification Activity

The Postal Rate Commission (PRC) 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 us, 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 impact 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 May 3, 2006, we filed a case with the 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 impact is less than \$6 per year for the average household.

Our Board of Governors also proposed a "forever stamp" as part of the broader rate adjustment plan. Customers would be able to purchase a special First-Class stamp, after the anticipated May 2007 rate change, which 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 continues to be challenging. Revenue growth for the remainder of the year will continue to be driven by the impact of our January 2006 rate increase. Expense growth for the year will likely be comparable to 2005. Sustained high fuel prices and higher wage rates, primarily driven by larger COLAs for our bargaining employees, will again be the main drivers behind fourth quarter expense growth.

Revenue Outlook

The revenue outlook for the remainder of the year remains positive. The long-predicted slowdown in macroeconomic growth appears to have arrived and does not appear to be severe, despite some bad news on the energy and housing fronts. The 5.4 percent rate increase should continue to act to depress mail volume growth slightly for the remainder of the year. However, since the demand for most of our services tends to be inelastic with respect to price, our revenue should increase.

Growth in economic activity (real GDP) slowed from 5.6 percent in the second quarter of 2006 to 2.5 percent for the third quarter. Macroeconomic forecaster Global Insight is calling for real GDP growth to end the fiscal year at 3.4 percent. Although real GDP is the bellwether macroeconomic measure, three other economic variables tend to influence demand for our services more directly: private sector non-farm employment, real retail sales, and real gross domestic investment spending. Of these measures, employment has most closely tracked mail volume growth over time. The outlook for employment growth has changed little in the last ten months.

Employment growth is expected to be about 1.6 percent, year-to-date, down only 0.1 percent from its growth rate in 2005. Real retail sales, a driver of both advertising mail and packages, are expected to grow 3.8 percent in 2006, slower than the 4.4 percent growth rate last fiscal year. Real Investment spending, which is correlated with advertising expenditures, is expected to grow 7.1 percent in 2006. This growth rate is somewhat inflated by the surge in spending associated with hurricane recovery efforts in the Gulf Coast region.

Looking ahead to 2007, growth in all four of these macroeconomic indicators will probably be less than in 2006. This expectation is based on the lagged effects of a convergence of negative economic trends. First, two years of interest rate increases by the Federal Reserve is expected to lead to depressed real investment spending, which Global Insight projects to grow at 1.7 percent in 2007. Second, increases in mortgage rates, increases in energy-related prices and the negative wealth effect of the softening housing market should continue to impact real retail sales, which are projected to grow at only 1.4 percent. Employment growth is projected to slow to 1.4 percent. The bottom line for real GDP is a projected growth rate of 2.7 percent for 2007, below the 3.1 percent growth trend of the last eight years.

Uncertainty continues in the macro-economy as evidenced by skittish financial markets, which seem to react to the perception of negative economic news. The double deficits (U. S. government budget and U.S. foreign trade), an unsustainable negative savings rate, short- and long-term changes in energy price trends as well as world demand for energy, and political instability in the Middle East and elsewhere have all been cited repeatedly in the last year as areas of concern.

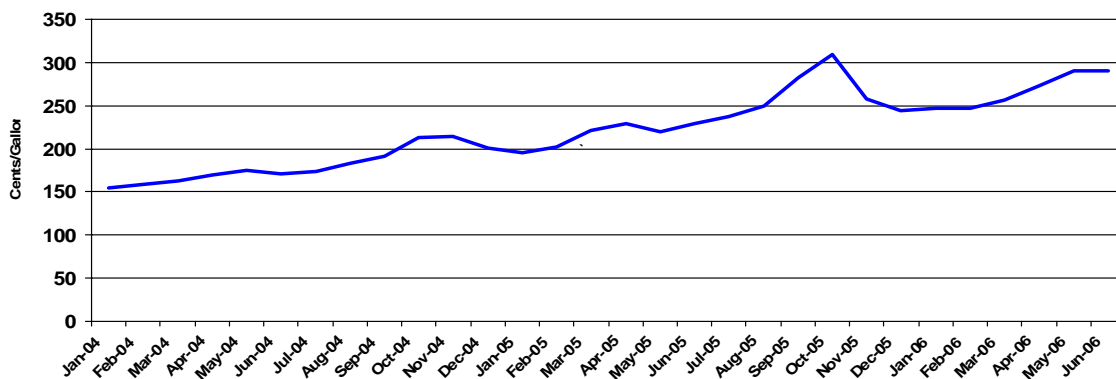
Our products should weather the slowdown reasonably well. Growth in workshare First-Class letter mail, Priority Mail and Express Mail volume has improved in 2006 and should continue into 2007. Standard Mail has not met expectations so far in 2006 as the consumer driven economy has cooled. If approved by the Postal Rate Commission, the proposed rate increase of about 8.5 percent should further slow volume growth but cause increased revenue growth around the middle of the calendar year.

Our delivery network expands each year and revenue growth is needed to support that expansion. Declines in single-piece First-Class Mail volume, which represent higher contribution margins, pose a challenge for our finances going forward. Single-piece First-Class letters contribute about \$9,000 million to cover institutional costs annually, about 28 percent of the total contribution. As this mail volume falls, other lower margin products must grow at ever increasing rates in order to replace the contribution lost. 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 below, 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 June. All of these factors have the potential to put significant upward pressure on costs for the remainder of the year and beyond.

US No 2 Diesel Retail (All Sellers)
(source U.S. Energy information Administration)



Pending Legislation

Postal Legislation

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.

The administration has required changes to the legislation and still believes that the legislation should be budget-neutral. The full text of the proposed legislation is located at the website <http://thomas.loc.gov/>.

The House and Senate continued to move forward to attempt to pass a postal reform bill. Both houses have passed their respective reform bills (H.R. 22 and S. 662) and must resolve the differences in a House-Senate Conference. The Senate named its conferees, while the House has yet to name its conferees while pre-conference negotiations continue. The primary issues being debated include the proposed price cap and the exigent rate case standard, cost control issues, and escrow. As of this date, the House and Senate are in recess until September.

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. While H.R. 923 has not moved, similar provisions were added to the House Defense Authorization bill for FY 2007 (H.R. 5122). This bill has passed the House and is ready for a House-Senate conference to resolve differences with the Senate version. The Senate Defense bill does not have such a mail benefit provision.

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 our 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 controls over financial reporting that are 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 June 30, 2006.

Part II. Other Information

Item 1. Legal proceedings

See Note 6, Contingent Liabilities, June 30, 2006 financial statements.

Item 5. Other information

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:

Ellen Williams, of Kentucky, for the remainder of a nine year term expiring December 8, 2007.
Katherine C. Tobin, of New York, for the remainder of a nine-year term expiring December 8, 2012.
Mickey D. Barnett, of New Mexico, for the remainder of a nine-year term expiring December 8, 2013.
James H. Bilbray, of Nevada, for the remainder of a nine year term expiring December 8, 2006 as well as reappointment to a second term of nine years expiring December 8, 2015.

The senate has confirmed all of the nominees.

Chief Financial Officer

Harold Glen Walker was named Chief Financial Officer and Executive Vice President, August 2, 2006 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 are on the following page:

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 employees represented by the APWU. The contract extension covers the period from November 20, 2005 through November 20, 2006. The agreement provided 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 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 to November 20, 2006. The agreement provided 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>.

August 3, 2006 - News Release #06-049

[Postal Service Names New Chief Financial Officer and Executive Vice President](#)

August 1, 2006 - News Release #06-048

[U.S. Postal Service, FedEx Express Agree To New Contract For Air Transportation of Mail](#)

July 14, 2006 - For Immediate Release

[Highlights of Postal Service Forever Stamp Filing with PRC](#)

July 3, 2006 - News Release #06-045

[Postal Service to Avoid \\$110 Million in Energy Costs Through Projects Financed by Other Companies](#)

June 28, 2006 - News Release #06-044

[Postal Service, United Parcel Service Expand Business Relationship](#)

June 13, 2006 - News Release #06-042

[Postal Service Honored With White House Closing The Circle Awards For Biodiesel Fuel And Recycling Programs](#)

May 31, 2006 - News Release #06-038

[New York \(JFK\) International Service Center Meets Global Standard For Excellence In International Letter-Mail Processing](#)

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](#)