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Quarterly Financial Report
For the Three Months Ended December 31, 2006

February 9, 2007

United States Postal Service
Quarterly Financial Report Index

United States Postal Service
Statements of Operations

(Dollars in millions)	December 31, 2006 (unaudited)	December 31, 2005 (unaudited)
Operating revenue	$ 19,663	$ 18,498
Operating expenses:		
Compensation and benefits - current employees	13,779	13,698
Compensation and benefits - retiree benefits	4,734	402
Transportation	1,806	1,509
Other	2,124	2,121
Total operating expenses	22,443	17,730
Income from operations	**(2,780)**	**768**
Interest and investment income	52	27
Interest expense on deferred retirement obligations	-	(65)
Other interest expense	(4)	(2)
Net (Loss) Income	**$ (2,732)**	**$ 728**

See accompanying notes to the financial statements

United States Postal Service
Balance Sheets - Assets

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(Dollars in millions)		December 31, 2006 (unaudited)		September 30, 2006 (audited)
Assets				
Current Assets				
Cash and cash equivalents	$	292	$	997
Cash - restricted		2,958		-
Receivables:				
Foreign countries		465		527
U.S. government		372		150
Other		233		210
Receivables before allowances		1,070		887
Less allowances		46		48
Total receivables, net		1,024		839
Supplies, advances and prepayments		166		205
Total Current Assets		**4,440**		**2,041**
Cash - Restricted		**-**		**2,958**
Appropriations Receivable - Revenue Forgone		**394**		**394**
Property and Equipment, at Cost:				
Buildings		21,190		21,083
Equipment		19,610		19,729
Land		2,888		2,887
Leasehold improvements		1,362		1,232
		45,050		44,931
Less allowances for depreciation and amortization		24,411		23,951
		20,639		20,980
Construction in progress		2,443		2,115
Total Property and Equipment, Net		**23,082**		**23,095**
Total Assets	$	**27,916**	$	**28,488**

See accompanying notes to the financial statements

United States Postal Service
Balance Sheets - Liabilities and Net Capital

(Dollars in millions)		December 31, 2006		September 30, 2006
		(unaudited)		(audited)
Liabilities and Net Capital				
Current Liabilities:				
Compensation and benefits - current employees	$	2,437	$	3,214
Compensation and benefits - retiree benefits		4,313		10
Payables and accrued expenses:				
Trade payables and accrued expenses		1,192		1,481
Foreign countries		558		567
U.S. government		69		111
Total payables and accrued expenses		1,819		2,159
Customer deposit accounts		1,684		1,647
Deferred revenue - prepaid postage		1,187		1,187
Outstanding postal money orders		866		885
Prepaid box rent and other deferred revenue		433		454
Debt		575		2,100
Total Current Liabilities		**13,314**		**11,656**
Non-Current Liabilities:				
Workers' compensation costs		7,132		6,869
Employees' accumulated leave		2,350		2,116
Deferred appropriations revenue		631		631
Long term portion capital lease obligations		633		637
Other		312		303
Total Non-Current Liabilities		**11,058**		**10,556**
Total Liabilities		**24,372**		**22,212**
Net Capital				
Capital contributions of the U.S. government		3,034		3,034
Retained earnings since reorganization		510		3,242
Total Net Capital		**3,544**		**6,276**
Total Liabilities and Net Capital	$	**27,916**	$	**28,488**

See accompanying notes to the financial statements

United States Postal Service
Changes in Net Capital

(Dollars in millions)	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital
Balance, September 30, 2006	$ 3,034	$ 3,242	$ 6,276
Net (Loss) - Three months Ended December 31, 2006 (unaudited)	-	(2,732)	(2,732)
Balance, December 31, 2006 (unaudited)	$ 3,034	$ 510	$ 3,544

See accompanying notes to the financial statements

United States Postal Service
Statements of Cash Flows

(Dollars in millions)	December 31, 2006 (unaudited)	December 31, 2005 (unaudited)
Cash flows from operating activities:		
Net income	$ (2,732)	$ 728
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	500	530
Gain on disposals of property and equipment, net	(19)	(2)
(Increase) in appropriations receivable revenue forgone	-	(6)
Increase in workers' compensation liability	242	288
Increase in employees accumulated leave	234	229
Increase in other non-current liabilities	9	(13)
Changes in current assets and liabilities:		
Increase in receivables, net	(185)	(36)
Decrease in supplies, advances and prepayments	39	39
Decrease in compensation and benefits-current employees	(756)	(422)
Increase in compensation and benefits - retiree benefits	4,303	2
Decrease in deferred revenue - prepaid postage	-	21
Decrease in payables and accrued expenses	(322)	(57)
Increase in customer deposit accounts	37	23
(Decrease) increase in outstanding postal money orders	(19)	44
Decrease in prepaid box rent and other deferred revenue	(21)	(29)
Net cash provided by operating activities	1,310	1,339
Cash Flows from investing activities:		
Purchase of property and equipment	(484)	(570)
Proceeds from sale of property and equipment	16	8
Net cash used in investing activities	(468)	(562)
Cash flows from financing activities:		
Issuance of debt	-	-
Payments on debt	(1,525)	-
Payments for capital lease obligations	(13)	(9)
U.S. government appropriations - received	-	-
U.S. government appropriations - expended	(9)	(17)
Net Cash used in financing activities	(1,547)	(26)
Net increase (decrease) in cash and cash equivalents	(705)	751
Cash and cash equivalents at beginning of year	997	930
Cash and cash equivalents at end of period	$ 292	$ 1,681

See accompanying notes to the financial statements

Item 1 – Notes to Financial Statements

Note 1 – Basis of Presentation

These interim financial statements reflect the results of operations of the United States Postal Service for the three months ended December 31, 2006, and 2005 and our financial position as of December 31, 2006, and September 30, 2006. 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 2006 Annual Report. As in the annual report, all references to years, unless otherwise stated, refer to our fiscal year beginning October 1 and ending September 30. 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.

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 our previously reported results of operations or our financial position.

In the opinion of management, the accompanying unaudited financial statements present fairly our financial position as of December 31, 2006, and September 30, 2006, the results of our operations and our cash flows for the three months ended December 31, 2006 and 2005. Operating results for the three-month period ended December 31, 2006, are not necessarily indicative of the results that may be expected for the year ending September 30, 2007.

Note 2 – Public Law 109-435 (P.L. 109-435), The Postal Accountability and Enhancement Act

P.L.109-435, enacted December 20, 2006, made significant reforms in the governance of the Postal Service and significantly altered some of our financial responsibilities, particularly in respect to the funding of Civil Service Retirement System (CSRS) benefits and retiree health benefits. The legislation does not change our parent-subsidiary type relationship as an independent establishment of the U.S. government. Our employees and retirees continue to participate in all federally sponsored retirement and health benefit plans. The U.S. government determines the extent and nature of these employee benefits and the funding requirements of these plans without our input. Therefore we will continue to account for our participation in U.S. government sponsored health benefit and retirement plans using multi-employer plan accounting rules in accordance with Financial Accounting Standards Board Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* and Financial Accounting Standards Board Statement 87, *Employers' Accounting for Pension Costs*.

Major provisions of the law directly impacting these financial statements are discussed below. The financial impacts are further discussed in the Management's Discussion and Analysis in this document; however, for a complete understanding, one must consult the full text of P.L.109-435, which can be found at www.Thomas.loc.gov.

P.L.109-435 returned to the U.S. Treasury the obligation to fund the portion of the retirement benefit for postal employees in CSRS that was earned while serving in the military. This obligation, estimated by the Office of Personnel Management (OPM) at $27 billion, was transferred from the Treasury to us in 2003 with the enactment of Public Law 108-18 (P.L.108-18). With the elimination of this obligation, the government has determined that we have fully funded both our CSRS pension obligation and our Federal Employees Retirement System (FERS) pension obligation. Recognizing that our pension obligations will be fully funded, the law exempts us from making any employer contribution to CSRS that would otherwise be required under Title 5, chapter 83, of the United States Code. This provision was effective October 14, 2006. See Note 9, *Retirement Programs,* for further discussion of this accounting treatment.

OPM is required by June 15, 2007, to determine the funded status of the CSRS and FERS plans as of September 30, 2006, and any over-funded amount will be transferred to the newly created Postal Service Retiree Health Benefits Fund.

We are also required by P.L.109-435 to make payments into the new Postal Service Retiree Health Benefits Fund. This Fund, which is held by the U.S. Treasury and controlled by OPM, will be used, commencing in ten years time to pay the health insurance premiums for our retired Postal Service employees. On average, the payment schedule in the law requires us to pay, in addition to our regularly allocated cost of premiums for current retirees, $5.6 billion per year into the fund for ten years, beginning in 2007. After these payments are complete, OPM will compute a new payment schedule to be designed to provide sufficient balance in the Fund by September 30, 2056, to pay all the health insurance premiums for retired Postal Service employees. We expensed $1.35 billion, representing one-fourth of the required $5.4 billion 2007 payment in Quarter I. We will expense the same amount in each subsequent quarter of 2007. See Note 9, *Retirement Programs,* for further discussion of this accounting treatment.

P.L.109-435 repealed the escrow provisions of P.L.108-18 which required us to place into an escrow account by September 2006, any "savings" from the change in the retirement provisions created by P.L.108-18. OPM calculated the savings at $2,958 million as of September 30, 2006. P.L.109-435 requires that the Postal Service pay the 2006 escrowed "savings" to the Postal Service Retiree Health Benefits Fund. As of December 31, 2006, these funds continue to be held by the Postal Service as restricted cash. However, since the legal requirement to disburse these funds and a designated specific purpose has been put in place, we have expensed the entire amount payable to the Postal Service Retiree Health Benefits Fund in our Quarter I financial statements as a component of compensation and benefits – retiree benefits. The liability to the Postal Service Retiree Health Benefits Fund is included on our balance sheet as a current liability.

Finally, P.L.109-435 also repealed the provision that required us to pay an additional annual amount known as a "supplemental liability," if necessary, each September, as determined by OPM. The "supplemental liability" represented 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. The "supplemental liability" payment anticipated for 2007 was $257 million. However, due to enactment of P.L.109-435, no supplemental liability principal or deferred retirement interest expense was recognized in Quarter I. The following table summarizes the impacts of the new legislation on our statement of operations at December 31, 2006.

P.L. 109-435 Comparison (Dollars in millions)	Prior to Public Law 109-435	P.L. 109-435 Impact	After Public Law 109-435
Line on Statement of Operations:			
Compensation and Benefits:			
Current Employees *	$ 14,090	$ (311)	$ 13,779
Retirees * *	433	4,301	4,734
Total Compensation and Benefits	14,523	3,990	18,513
Deferred Retirement Interest	58	(58)	-
Net Income (Loss)	$ 1,200	$ (3,932)	$ (2,732)
Explanation of impact on Compensation and Benefits expense			
* Discontinuance of CSRS employer contributions		$ (311)	
** Repeal of "Suplemental Liability" principal		$ (7)	
Postal Service Retiree Health Benefit Fund expense (3 months)		1,350	
Postal Service Retiree Health Benefit Fund expense (escrow transfer)		2,958	
Subtotal		$ 4,301	

Note 3 – Debt and Related Interest

Under the Postal Reorganization Act, as amended by P.L.101-227 and P.L.109-435, we can issue and sell debt obligations. However, we are limited to total debt outstanding of $15 billion and to net annual increases of $3 billion.

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 days notice.

At December 31, 2006, our debt consisted of $575 million drawn on our line of credit with the Federal Financing Bank. At September 30, 2006, our debt consisted of $2,100 million also drawn on the Federal Financing Bank.

Note 4 – Property and Equipment

We record property and equipment at cost, including the interest we pay on the money we borrow to pay for the construction of major capital additions. We had no interest capitalized or newly impaired assets during the three months ended December 31, 2006, and 2005.

Note 5 – Foreign Currency Translation

We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail. The majority of our international accounts are denominated in special drawing rights (SDRs). The SDR exchange rate fluctuates daily, based on a basket of currencies comprised of the euro, Japanese yen, pound sterling, and the U.S. dollar. Changes in the relative value of these currencies will increase or decrease the value of our settlement accounts and result in a gain or loss from revaluation reported in the results from operations. The actual currency used to settle accounts varies by country. The impacts on our financial statements from foreign currency fluctuations were insignificant for Quarter I of 2007 and 2006.

Note 6 – Commitments

Commitments consist of capital and expense commitments. Capital commitments consist of capital lease obligations for buildings and contracts for capital items such as equipment, building improvements, construction, and vehicles. Expense commitments consist of operating lease obligations for buildings, and contracts for normal operational expense items that have been purchased under a contract. Expense commitments also include inventory and research and development contracts. Resources on Order, reflects our current commitments for each item.

CAPITAL

At December 31, 2006, and September 30, 2006, we estimate our financial commitment for approved capital commitments to be $2,332 million and $2,760 million respectively as detailed below. Our future minimum lease payments for all non-cancelable capital leases are also shown below.

Capital Resources on Order (Dollars in millons)	December 31, 2006	September 30, 2006
	(unaudited)	(audited)
Mail Processing Equipment	$ 1,225	$ 1,483
Postal Support Equipment	465	476
Building Improvements	410	517
Construction and Building Purchase	185	228
Vehicles	9	18
Retail Equipment	38	38
Total	$ 2,332	$ 2,760

Capital Lease Obligations (Dollars in millions)	December 31, 2006
	(unaudited)
2007	$ 75
2008	98
2009	97
2010	94
2011	91
After 2011	659
Total Lease Obligations	$ 1,114
Less: Interest	454
Total Capital Lease Obligations	$ 660
Less: Short-term portion of capital lease	27
Long-term Portion of Capital Lease	$ 633

EXPENSE

At December 31, 2006 and September 30, 2006, we estimate our financial commitment for approved expense commitments to be $5,495 million and $5,177 million respectively as detailed below. Our future minimum lease payments for all non-cancelable operating lease obligations are also shown below.

Expense Resources on Order (Dollars in millons)	December 31, 2006	September 30, 2006
Operational Contracts	$ 5,188	$ 4,885
Inventory Contracts	263	253
Research and Development Contracts	44	39
Total	$ 5,495	$ 5,177

Operating Leases (Dollars in millions)	December 31, 2006
	(unaudited)
2007	$ 568
2008	734
2009	703
2010	653
2011	594
After 2011	5,089
Total Lease Obligations	$ 8,341

Our rental expense on operating leases is shown in the following table:

Rental Expense (Dollars in millions)	Three Months Ended December 31, 2006	2005
Non-cancelable real estate leases including related taxes	$ 236	$ 232
Facilities leased from GSA subject to 120-day cancellation	11	11
Equipment and other short-term rentals	54	40
Total Rental Expense	$ 301	$ 283

Note 7 – 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, issues arising from postal contracts, personal claims, 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 payout 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. The table summarizes our contingent liabilities provided for in the financial statements.

Contingent Liabilities (Dollars in millions)	December 31, 2006	September 30, 2006
	(unaudited)	(audited)
Labor Cases	$ 264	$ 254
Equal Employment Opportunity Cases	66	66
Tort Cases	59	57
Environmental Cases	25	25
Contractual Cases	14	16
Total	$ 428	$ 418

Management and the General Counsel believe that adequate provision has been made for the probable amounts due from claims and suits. Amounts we expect to pay in the next year are current liabilities on the balance sheets under the heading "Trade payables and accrued expenses." The long-term portion of the liability is accrued under the heading "Other Non-Current Liabilities" in our financial statements.

We also have similar cases which we deem reasonably possible and for which we cannot yet determine the amounts or a reasonable range of potential losses in these matters, if any. No provisions for these are included in our financial statements.

Note 8 – Health Benefits

Substantially all of our current employees are covered by the Federal Employee Health Benefits Program (FEHBP). The OPM administers the program and allocates the cost of the program to the various participating government agencies. We cannot direct the costs, benefits, or funding requirements of the federally sponsored plan.

Health benefit costs for our current employees were $1,201 million during the first quarter of this year compared to $1,160 million in the same period last year.

Long-term care insurance is available through the federal government at the employee's expense.

Note 9 – Retirement Programs

RETIREE HEALTH BENEFITS

Employees who participate in the FEHBP for at least the five years immediately before their retirement may participate in the FEHBP during their retirement. The Omnibus Budget Reconciliation Act of 1990 requires us to pay the employer's share of health insurance premiums for all employees and their survivors who participate in the FEHBP and who retire on or after July 1, 1971. However, we do not include the costs attributable to federal civilian service before that date. We account for our participation in FEHBP using multi-employer plan accounting rules in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.*

With passage of P.L.109-435, we continue to make monthly payments to OPM for FEHBP. During the Quarter I we paid $426 million to OPM for retiree health benefits. This was an increase over the same period last year by $31 million.

Additionally, we will be making payments into a new Postal Service Retiree Health Benefits Fund held by the U.S. Treasury and controlled by OPM. For 2007, the required contribution to the fund is $5.4 billion, which we are expensing at the rate of $450 million per month. Also as stated in Note 2, *Public Law 109-435,* with the passage of P.L.109-435, the funds held in escrow, $2,958 million, which are now payable to the Postal Service Retiree Health Benefits Fund, were expensed in our Quarter I financial statements.

Postal Service Retiree Health Benefit Fund Schedule of Future Payments (Dollars in millions)		Expense
2007	$	5,400
2008		5,600
2009		5,400
2010		5,500
2011		5,500
After 2011		28,400
10-Year Total	$	55,800

We will be contributing an average payment each year of $5.6 billion to the Postal Service Retiree Health Benefits Fund for a period of ten years. At that point, the fund will begin to pay premiums allocated to us from FEHBP for postal retirees. During the ten-year period we will continue to pay retiree health benefits as invoiced by OPM.

PENSION PROGRAMS

Our employees participate in one of the following pension programs based upon the starting date of their employment with the Federal Government. Employee and employer contributions are made to CSRS, the Dual CSRS/Social Security (Dual/CSRS), or the FERS, all of which are administered by OPM. Employees may also participate in the Thrift Savings Plan (TSP), which is a defined contribution retirement savings and investment plan. The Plan is administered by the Federal Retirement Thrift Investment Board.

P.L.109-435 exempts us from making any employer contribution to the CSRS, otherwise required under Title 5, chapter 83, of the United States Code. This provision was effective October 14, 2006, and reduced the employer portion of the CSRS contribution by $311 million. As a result, our retirement expenses for Quarter I were $1,501 million, compared to $1,744 for the same period last year.

P.L.109-435 also repealed the provision which required us to pay an additional annual amount known as a “supplemental liability”, if necessary, each September as determined by OPM. The "supplemental liability" represented 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. The “supplemental liability” payment, including principal and interest, anticipated for 2007 was $257 million. Due to the repeal of this provision by P.L.109-435, there was no expense associated with the supplemental liability in Quarter I of 2007, compared to $73 million in the same period last year.

The following table reflects our current contributions for retirement:

Retirement Contribution	Three Months Ended December 31,	
(Percentage)	2006	2005
CSRS Employer	**-**	**17.4**
CSRS Employee	**7.0**	**7.0**
Dual CSRS Employer	**-**	**18.0**
Dual CSRS Employee	**0.8**	**0.8**
FERS Employer	**11.2**	**11.2**
FERS Employee	**0.8**	**0.8**

Note 10 – Workers’ Compensation

We pay for workers’ compensation costs under a program administered by the Department of Labor (DOL). These costs include employees’ medical expenses, payments for continuation of wages, and DOL administrative fees. We record these costs as an operating expense. Our quarterly expense for workers’ compensation was $275 million during Quarter I of 2007, compared to $299 million for the same period last year.

Note 11 – Revenue Forgone

Revenue Forgone is an appropriation from Congress which covers our cost of providing free and reduced rate mailing service to groups designated by Congress. During Quarter I 2007, we recognized $15 million for Revenue Forgone appropriations, compared to $21 million during the same period last year.

Note 12 – Emergency Preparedness Funding

We recognize revenue from Emergency Preparedness Appropriations as we depreciate the capital equipment purchased with the appropriation. The Emergency Preparedness Appropriations revenue and corresponding depreciation expense recognized during Quarter I was $13 million, compared to $17 million in the same period last year. A reevaluation of the expected useful life of the Bio-Detection System equipment from five years to ten years resulted in a reduction of depreciation.

Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

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 2006 Annual Report. As in the Annual Report, all references to years, unless otherwise stated, refer to our fiscal year beginning October 1st and ending September 30th.

Introduction

The United States Postal Service (we) commenced operations on July 1, 1971, as an independent establishment of the executive branch of the United States government. We are governed by an eleven member Board of Governors. The Board is composed of nine Governors appointed by the President of the United States with the advice and consent of the Senate, the Postmaster General and the Deputy Postmaster General. Under the Postal Reorganization Act, we have a legal mandate to offer a "fundamental service" to the American people. We fulfill this legal mandate by offering a variety of classes of mail services without undue discrimination among our many customers. This means that within each class of mail our price does not unreasonably vary by customer for the levels of service we provide.

We compete for business in the communications, distribution, delivery, advertising and retail markets. The rates and fees for postal services are subject to a regulatory review process controlled by the independent Postal Regulatory Commission (PRC).

We have a very diverse customer base and we are not dependent upon a single customer or small group of customers. We do not report revenue from individual customers. No single customer represents more than 2% of our revenue.

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 PRC. See the Postal Accountability and Enhancement Act section below for a discussion of changes to the PRC and their role in the rate setting process.

Our mailing services (products) are sold through our almost 37,000 Post Offices, stations, branches, contract postal units, our website www.usps.com and a large network of consignees. We deliver mail to almost 147 million city, rural, Post Office box and highway delivery points. We conduct our operations primarily in the domestic market, with international operations representing less than 3% of our total revenue.

We operate and manage an integrated retail, distribution, transportation and delivery network. As such, our physical infrastructure and our labor force are not dedicated to individual products or separate product lines, with limited exceptions. Expenses are incurred and managed by functional groupings that align with the integrated network structure. Reporting of expenses on a functional basis in this report comports with the management of and structure of expense incurrence within our organization.

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Over 85% of our career employees are covered by collective bargaining agreements. Refer to Item 5, *Other Information*, in Part II for additional information.

By law, we consult with management organizations representing most of the employees not covered by collective bargaining agreements. These consultations provide the organizations an opportunity to participate directly in the planning, development, and implementation of programs and policies affecting non-bargaining employees in the field. Our 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 as required by statute, for retirement, health benefits and workers' compensation.

Beginning in 2008, we will be required to produce, publish and file financial reports with the PRC that comply with certain Securities and Exchange Commission (SEC) rules and regulations on financial reporting. Currently, we are guided by SEC reporting requirements to the extent deemed practical for a non-publicly traded, government-owned entity. 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.

Postal Accountability and Enhancement Act, Public Law 109-435

The postal legislation signed into law by President Bush on December 20, 2006, is intended to benefit both residential and business customers by seeking to achieve predictable price increases tied to the rate of inflation. The new law, called the Postal Accountability and Enhancement Act, is the first major change to the statute governing the Postal Service since 1971.

The law directs the Department of the Treasury to resume the obligation for military pensions for postal employees, taking the financial burden added by P.L.108-18, estimated at approximately $27 billion, off the Postal Service. That means our CSRS obligations are now fully funded. The Law abolishes a federally mandated escrow requirement (the purpose of which was unspecified) and directs that money be placed into a new Postal Service Retiree Health Benefits Fund. Over the next ten years we will also make payments into the fund that average $5.6 billion per year. By 2017, we expect our retiree health benefits will be substantially fully funded. We estimate the effect on our available cash will be a reduction of $600 million to $700 million in 2007, which in turn will increase our anticipated debt at the end of the year.

For our retail customers, the new law anticipates that universal service can be preserved at affordable rates. For commercial mailers it is intended to provide rate predictability. And for employees, ratepayers and taxpayers it should assure that the employer portion of the Postal Service's health and retirement benefits obligations is fully funded.

The new law divides our services into two broad categories: market-dominant and competitive. Market-dominant services include, but are not limited to, First-Class Mail, Standard Mail and Periodicals. Future rate increases for these services will be tied to the Consumer Price Index. Competitive product services, such as Priority Mail and Express Mail, Bulk Parcel Post and Bulk International Mail will enjoy greater pricing flexibility.

P.L.109-435 also reconstitutes the former Postal Rate Commission into a regulatory body, renamed the Postal Regulatory Commission. The PRC has 18 months to develop regulations for both market-dominant and competitive products. The Postal Service is allowed to file one last rate case under the current rules, not later than December 20, 2007. The current rate case will proceed as scheduled. In changing from the Postal Rate Commission to the Postal Regulatory Commission, the PRC will now have its own office of the Inspector General. The Postal service will continue to be required to provide the funding for our Office of Inspector General (OIG), the PRC and the PRC's OIG.

Additionally, P.L.109-435 requires the Postal Service, beginning in 2008, to file with the PRC a number of financial reports not previously required. These include quarterly reports containing information required by the SEC to be filed on Form 10-Q within 40 days after the end of each quarter, an annual report containing the information required by the SEC on Form 10-K within 60 days of the end of each fiscal year, and periodic reports containing the information prescribed by the SEC on Form 8-K within the prescribed time frames. Further, P.L.109-435 requires that the Postal Service comply with the rules prescribed by the SEC implementing section 404 of the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley requirement is effective beginning with the 2010 annual report. The exact cost of complying with Section 404 of the Sarbanes-Oxley Act is not yet known. Our external auditor's professional fees will also increase in order for us to comply with the requirements under this act, as well as with our requirements to file SEC 10Q and 10K reports with the PRC.

Since we will no longer be holding funds in escrow, we will no longer have the interest earnings on the escrow account. The reduction of interest income will be over $100 million per year. There will also be increased borrowing to cover the additional cash outlays which will increase our interest expense.

Finally we cannot yet estimate the additional costs associated with modifying any of our systems that will be required to separate the business into market dominant and competitive products and services and any other additional costs as a result of the new law.

The projected financial impacts of P.L.109-435 are reflected in the table:

Financial Impacts under P.L.109-435 (Dollars in billions)	Quarter I (unaudited)
Income from Operations	$ 1,200
P.L.109-435 Impacts:	
2006 escrow transferred into PSRHBF	(2,958)
2007 PSRHBF expense	(1,350)
CSRS savings	376
Net Loss	$ (2,732)

Results of Operations

Quarter I operating revenue was $19,663 million, compared to $18,498 million in the corresponding quarter of last year, an increase of $1,665 million or 6.3%. This is the last quarter that we will show a comparative benefit from last January's rate increase. The largest component of the revenue increase came from Standard Mail, which increased almost $460 million. First-Class Mail increased $439 million. This revenue increase was accompanied by a total volume increase of 1.3 billion pieces in Quarter I to a total of 57.2 billion pieces, 2.3% above Quarter I of last year. Standard Mail accounted for substantially all of the volume increase with 1.3 billion additional pieces or 4.9% in Quarter I. This was largely due to additional campaign mailing activity during the mid-term elections.

For Quarter I, operating expenses grew by 26.6%. However, after subtracting the impact of P.L.109-435, operating expenses were 4% higher than the same quarter last year. Compensation and benefits expense for current employees increased slightly, by $81 million, over the comparable period last year. The big increase was in compensation and benefits for retirees. P.L.109-435 added over $4.3 billion in expense for the new Postal Service Retiree Health Benefit Fund in Quarter I. The results for the quarter ending December 31 was a net loss of $2,732 million, compared to a net income of $728 million in the same quarter last year. Without the expense of the new Postal Service Retiree Health Benefit Fund, we would have had a net income of $1.2 billion for Quarter I.

Summary Interim Financial Results (Dollars in millions)	Three Months Ended December 31, 2006	 2005
Operating Revenue	$ 19,663	$ 18,498
Operating Expenses:		
Compensation and benefits - current employees	13,779	13,698
Compensation and benefits - retiree benefits	4,734	402
Transportation	1,806	1,509
Supplies and services	532	489
Depreciation and Amortization	500	530
Other expenses	1,092	1,102
Total Operating Expenses	22,443	17,730
Income (loss) from Operations	(2,780)	768
Interest and investment income	52	27
Interest on deferred retirement obligations	-	(65)
Other interest expense	(4)	(2)
Net (Loss) Income	$ (2,732)	$ 728

Volume

Mail volume from the *Revenue, Pieces and Weight* report are preliminary for each quarter and are finalized at the end of each year. There is some slight recasting of numbers compared to the preliminary results presented at December 31, 2005.

First-Class Mail volume was relatively flat, declining 6.5 million pieces in the first quarter compared to the same period last year. Single-piece First-Class Mail declined 204 million pieces or 1.7%. This was offset by a 198 million piece gain, or 1.5%, in workshare letters and cards.

Standard Mail volume grew 4.9% in the first quarter. Growth was strong in all four subclasses. Volume growth in commercial Standard Mail subclasses was 4.3%. Nonprofit Standard Mail grew 8.2%, bolstered by a 32.6% surge in Nonprofit ECR mail. The growth in Standard was bolstered by election-related mailings. Also, competition in the financial services, cable television and telecommunications industries contributed to increased use of Standard Mail during the quarter.

Mail Volume by Type	Three Months Ended December 31,	
(Pieces in millions)	2006	2005
Standard Mail	28,403	27,072
First-Class Mail	25,432	25,438
Periodicals	2,172	2,294
Package Services	329	326
Priority Mail	252	249
Express Mail	14	14
International	244	237
Other *	331	234
Total	57,177	55,864

* Postal Service mailing volume and free matter for the blind included in the "Other" category.

Periodical Mail volume fell 122 million pieces or 5.3% in the first quarter. Periodicals volume is trending downward over the long term, reflecting trends in reading behavior. This quarterly volume decline was nonetheless surprisingly sharp. The decrease was especially pronounced in the nonprofit subclass. Nonprofit Periodicals decreased 9.5% for the quarter.

Package Services volume increased 3.5 million pieces or 1.1% in Quarter I. Volume declines of 7.8% in Parcel Post and 8% in Media Mail were offset by a strong showing for Bound Printed Matter. Bound Printed Matter volume increased 10.7%. Parcel Post results reflect the disruptive impact of bankruptcies in the consolidator industry in early 2006. The decline in Media Mail volume reflects the effect of the rate increase coupled with continued migration of Media Mail to Bound Printed Matter.

Priority Mail volume growth slowed to 2.7 million pieces or 1.1% in Quarter I. This is the tenth consecutive quarter of positive growth in Priority Mail volume. Growth slowed however, as a result of the rate increase. We continue to work to improve Priority Mail service performance and make Priority Mail easy to use. Customers can purchase postage and print mailing labels with free delivery confirmation on-line at http://www.usps.com/onlinepostage/, through Click-N-Ship, while Carrier pickup saves customers a trip to the Post Office and our flat rate envelope and flat rate box simplify Priority Mail use further. Finally, the surge in passport applications associated with changes in rules regarding air travel to Mexico, Canada and the Caribbean has provided a temporary boost to Priority Mail.

Express Mail volume declined 0.4 million pieces or 3.1% for the quarter. Express Mail is the most price sensitive class of mail so this decrease was not unexpected. Like Priority Mail, Express Mail had benefited from the impact of surcharges imposed by private sector competitors and the small short term boost from passport fulfillment.

International Mail originating in the United States increased 3% or 7.2 million pieces in Quarter I of 2007. Most of this growth can be attributed to the 25% increase in International Surface Airlift Mail.

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 95.5 million pieces or 40.9% in Quarter I, mainly as a result of a continuing Postal Service promotional campaign.

Revenue Analysis

Rates for most of our products and services increased, on average, 5.4% on January 8, 2006. Because of rate design considerations, some products and services of mail received increases slightly more or less than 5.4%. Analysis of the impact on each category follows:

Standard Mail revenue grew $459 million or 9% in Quarter I compared to the same period last year. The rate increases for Standard Mail averaged approximately 5% for commercial Standard and 5.7% for Nonprofit Standard. As mentioned earlier, the growth in Standard Mail has been bolstered by election-related mailings, financial services, cable television and telecommunications mailings.

First-Class Mail revenue increased $439 million or 4.7%, in Quarter I which is slightly less than the 5.4% increase in rates. Shifts in the mail mix away from single-piece mail toward workshare mail account for the 0.7% gap.

The large volume decline for Periodicals resulted in a decrease in revenue of about $8 million compared to the same period last year, despite the rate increase.

Package Services revenue increased $34 million or 5.5% in Quarter I compared to the first quarter of 2006. Bound Printed Matter revenue increases accounted for $22 million of the revenue increase. The rest of the increase is attributable to the rate increase for Parcel Post, Media Mail and Library Mail.

Priority Mail revenue grew $106 million or 7.8% in Quarter I compared to the same period last year. The increase is the result of three factors: the rate increase, the volume increase and an increase of 2.9% in average weight per piece. The increase in average weight reflects the success of the Flat Rate Box.

Revenue (Dollars in millions)	Three Months Ended December 31, 2006	2005
Standard Mail	$ 5,543	$ 5,084
First-Class Mail	9,772	9,333
Periodicals	546	554
Package Services	653	619
Priority Mail	1,464	1,358
Express Mail	238	231
International	559	523
Other *	888	796
Operating Revenue	$ 19,663	$ 18,498
Interest Income	52	27
Total Revenue	$ 19,715	$ 18,525

* Included in the "Other" category are special service revenue, other income and investment income.

Express Mail revenue grew $7 million or 3% in Quarter I compared to the same period last year. This reflects the combination of the rate increase and an average 3% increase in weight per piece.

Revenue from International Mail increased $38 million or 7.3% in Quarter I compared to the same period last year. International revenue includes revenue from foreign postal transactions not included in volume estimates.

Other revenue, which includes special services, increased $92 million or 11.6% in Quarter I compared to the same quarter last year. Special services revenue increased $58 million or 9.8% driven by Certified Mail and Delivery Receipt Services. Passport fees, driven by new Homeland Security passport requirements grew by $28 million or 67% in the first quarter. A gain on the sale of real estate sales accounted for the remainder of the growth.

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.

When we determine that our funds on-hand exceed our current needs, we invest those funds with the U.S. Treasury's Bureau of Public Debt in overnight securities issued by the U.S. Treasury. During Quarter I, we earned $52 million from our short-term investment activity, compared to $27 million for the same period last year. Increased cash on hand and higher interest rates compared to the Quarter I of last year were the reasons for the growth.

Operating Expenses – Compensation and Benefits

COMPENSATION AND BENEFITS – CURRENT EMPLOYEES

Compensation and benefits for our current employees for Quarter I was $13,779 million only slightly higher than the prior year period amount of $13,698 million. The increase of $81 million was mitigated by a reduction in the employer share of the CSRS contribution of $311 million. The reduction is a direct result of P.L.109-435, which eliminated future employer contributions to the CSRS fund since we are now fully funded.

COMPENSATION AND BENEFITS – RETIREE BENEFITS

Benefit expenses for our retirees was $4,734 for the quarter ended December 31, 2006. This increase of $4,332 million was driven by P.L.109-435 and the additional expenses for the new Postal Service Retiree Health Benefits Fund of $4,308 million. Without the legislation, retiree benefit expenses would have been $433 million compared to $402 million for the same period last year.

Under P.L.109-435, we have been provided a ten year payment schedule, which is spelled out in the legislation requiring that we pay $5.4 billion into the fund by September 30, 2007. We expensed one-fourth of this $5.4 billion annual payment in Quarter I. In addition, with the requirement that we transfer the $2,958 million held in escrow under the provisions of P.L.108-18 to the Postal Service Retiree Health Benefits Fund, we also expensed that amount in Quarter I. These items combine to total $4,308 million in new expense that are not reflected in the comparative statements of Quarter I, 2006. See Note 2, *Public Law.109-435* and Note 9, *Retirement Programs* for further discussion of this accounting treatment.

Compensation, Benefits and Work Hour Analysis	Work Hours Three Months Ended December 31, 2006	2005	Salaries and Benefits Three Months Ended December 31, 2006	2005
	(Work Hours in thousands)		(Dollars in millions)	
City Delivery	118,391	119,433	$ 4,485	$ 4,354
Mail Processing	86,630	89,630	3,093	3,070
Customer Services & Retail	61,720	63,440	2,292	2,244
Rural Delivery	46,615	46,280	1,443	1,362
Plant & Equipment Maintenance	20,409	20,303	823	779
Vehicle Services	8,189	8,145	329	312
Operations Support	2,403	2,358	113	107
Postmasters, Managers, Supervisors, Administration and Other	24,611	25,306	786	1,079
Subtotal	368,968	374,895	13,364	13,307
Other Compensation				
Workers' Compensation			275	299
Retiree Health Benefits			426	395
Postal Service Retiree Health Benefit Fund			4,308	-
Other			140	99
Total	368,968	374,895	$ 18,513	$ 14,100

WAGES

Wages increased $315 million in Quarter I compared to same period last year. This is due to increases in wage rates and overtime usage. In November 2006, Mail Handler and Rural Carrier bargaining unit employees received pay increases of 1.2%, while Clerk bargaining unit employees received an increase in pay of 1.3%. In addition, almost all bargaining unit employees received annualized COLA increases ranging from $791 to $812 per eligible employee in

September 2006. The September 2006 COLA was responsible for $144 million of the increase in wages in the quarter ended December 31, 2006. Our cost of providing health benefits to current employees increased by $461 million over the same quarter last year.

WORK HOURS

A change in work hours is usually created by a change in workload, a change in productivity, or both. The two major workload factors that impact our operations are changes in mail volume and changes in possible deliveries. In our first quarter, mail volume increased by 1.3 billion pieces, or 2.3%, and we added almost 1.8 million new delivery points since the same quarter last year. Total work hour usage declined 5.9 million hours or 1.6% from the comparable period last year. There was one less business day in our first quarter compared to the same period last year. Mail processing work hours declined by 3 million hours, city delivery operations work hours declined by 1 million hours, and customer service and retail work hours decreased by almost 2 million hours.

WORKERS' COMPENSATION

Our employees are covered by the Federal Employees' Compensation Act, administered by the DOL 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 the cost per claim. Workers' Compensation expense decreased $24 million compared to the same period last year. In Quarter I of 2007 we experienced a decrease in claims of 7,598, or 6.8%, in paid medical claims and increase in paid compensation claims of 657 or 1.5%. In 2006, our paid medical claims decreased by 2.3% and our paid compensation claims decreased by 1.7%.

RETIREE HEALTH BENEFITS

Under the FEHBP, the OPM charges us for the cost of our retirees participating in the plan. The major drivers of Retiree Health Benefits expense are the number of current participants on the rolls and inflation in premium costs. As of December 31, 2006, we had approximately 447,000 participants on the rolls, an increase of about 1,400 over the prior year. Our expense related to retiree health benefits was $426 million during this quarter, compared to $395 million in the first quarter of 2006, an increase of 7.8%. See the *COMPENSATION AND BENEFITS – RETIREE BENEFITS* section above for the impact of P.L.109-435.

RETIREMENT EXPENSE

Our employees participate in one of three retirement programs based on their date of employment. These programs are the CSRS, the Dual CSRS/Social Security System Plan, and the FERS Plan. Each of these programs is described in further detail in Note 9, *Retirement Programs* in Part I of the Financial Information section. The programs are administered by OPM. The expenses of all of our retirement programs are included in compensation and benefits expense.

Retirement expenses remain a significant portion of our total expense. During Quarter I, our retirement expense for the CSRS, Dual/CSRS and FERS plans was $1,501 million. This was below the same period last year by 14% or $243 million. The reduction was due to the passage of the Postal Accountability and Enhancement Act which reduced the employer contributions for CSRS employees.

EMPLOYEE COMPLEMENT

Employee complement was reduced by 1,796 during Quarter I. The total number of career employees at the end of the quarter was 694,342. This represents a reduction of 8,233 employees from the same quarter last year, all through attrition.

Operating Expenses – Transportation

Transportation expenses were $1,806 million, an increase of $297 million, or 10.7% for Quarter I. Transportation costs are largely made up of air and highway transportation.

Air transportation expenses were $904 million, an increase of $203 million or 29% over the same quarter last year. This is primarily attributed to additional holiday peak service flights which increased costs $116 million. Other increases included non-fuel charges of $32 million, terminal dues settlements with foreign administrations of $28 million, domestic excise taxes of $6 million and additional contract mail handling of $5 million. Fuel prices were relatively flat, increasing only $2 million over the same quarter last year.

Highway transportation expenses of $793 million increased by $32 million or 4.2% over the same quarter last year. The increase was driven primarily by contractual wage increases for drivers of $18 million and extra service contracts of $10 million. Highway contract route growth added additional deliveries resulting in an increase of $4 million.

Transportation Expense (Dollars in millions)	Three Months Ended December 31, 2006	2005
Air Transportation	$ 904	$ 701
Highway Transportation	793	761
Other Transportation	109	47
Total	$ 1,806	$ 1,509

Other transportation expenses including rail service increased $62 million or 132% over the same period last year. The increase was driven primarily by $56 million in additional charges for terminal dues, with Canada accounting for $40 million of the increase.

Other Operating Expenses

Other operating expenses of $2,124 million were essentially flat, only $3 million higher than last year's comparable quarter.

SUPPLIES AND SERVICES

Supplies and services expenses of $565 million were $41 million or 7.8% higher than the same period last year. The increase in supplies and service expenses reflect an increase in supplies of $10 million, additional contractor and professional services of $15 million and additional credit and debit card transaction fees of $9 million.

Other Operating Expenses (Dollars in millions)	Three Months Ended December 31, 2006	2005
Supplies and Services	$ 565	$ 524
Depreciation and Amortization	500	530
Rent and Utilities	410	403
Vehicle Maintenance Service	163	170
Information Technology and Communications	152	140
Rural Carrier Equipment Maintenance Allowance	117	112
Other	217	242
Total	$ 2,124	$ 2,121

DEPRECIATION AND AMORTIZATION

Depreciation and amortization expense of $500 million was $30 million less than last year's comparable quarter. This was largely due to our POS ONE retail terminals becoming fully depreciated, reducing our depreciation expense by almost $10 million per month.

VEHICLE MAINTENANCE SERVICE

Vehicle maintenance decreased by $7 million in Quarter I of 2007 when compared to the same period last year. This is due to slightly lower fuel prices during the quarter.

INFORMATION TECHNOLOGY AND COMMUNICATIONS

Information technology and communications expenses increased by $12 million or 8.6% compared to the same period last year. Our communications costs rose by $8 million due to an increase from integrated internet service costs.

Interest Expense

Other interest expense of $4 million was $2 million higher than last year's comparable quarter. The $4 million is our interest on borrowing and mortgage interest expense and reflects the fact that we had outstanding debt during the current quarter compared to no debt at December 31, 2005. At September 30, 2006, we had $2.1 billion in debt, which was paid off on October 3, 2006. During the remainder of the quarter we added small amounts of debt and ended Quarter I with $575 million in debt outstanding. Our low interest expense reflects the large reduction which occurred after the close of our fiscal year.

The passage of P.L.109-435 abolished the supplemental retirement payment and its associated deferred retirement interest expense, which was $65 million last year.

Debt and Liquidity

As of December 31, 2006, we had outstanding debt with the U.S. Treasury's Federal Financing Bank of $575 million versus $2.1 billion on September 30, 2006. Cash and cash equivalents were $292 million, $705 million lower than the September 30, 2006 balance of $997 million. For the quarter, cash flow from operating activities was $30 million lower this year, while net cash used in investing activities (capital outlays) was $91 million lower. This year, we used the net cash flow from operations, after paying for capital investments, plus a reduction in cash, to pay off $1,525 million in debt. Last year, with no debt to repay, the net cash flow increased cash and cash equivalents.

We anticipate very little borrowing until the end of the fiscal year. In September, we have a workers' compensation lump sum payment of approximately $1 billion. We will also be transferring $2,958 million of restricted cash to the Postal Service Retiree Health Benefit Fund in 2007. Additionally, this year's cash flow from operations will not supply enough cash to fund both the new Postal Service Retiree Health Benefit Fund payment requirement of $5.4 billion and capital investments. Our financing projection entering the year was for a net increase in debt of $1.2 billion over the September 30, 2006 level of $2.1 billion. We estimate that the passage of P.L. 109-435 negatively impacted cash flow for the year by $600 to $700 million. Consequently, we now anticipate an increase in debt outstanding for the year of approximately $1.8 billion and an ending debt balance of approximately $3.9 billion.

Capital Expenditures and Commitments

Commitments consist of capital and expense commitments. Capital commitments consist of capital lease obligations for buildings and contracts for capital items such as equipment, building improvements, construction and vehicles. Expense commitments consist of operating lease obligations for buildings and contracts for normal expense items that have been purchased under a major contract, such as miscellaneous contracts, inventory contracts and research and development contracts.

CAPITAL COMMITMENTS, EXPENDITURES AND RESOURCES ON ORDER

Total capital resources on order were $2,332 million at December 31, 2006, see Note 6, *Commitments* in Part I of the Financial Information. New capital commitments during Quarter I were $166 million compared to $153 million in the same period last year. During Quarter I of 2007, the Board of Governors approved funding for one project, Flat Sequencing System, Phase 1, to automate the handling of flat mail in targeted high volume zones.

The capital cash outlays during Quarter I were $484 million compared with $570 million in Quarter I of 2006.

Capital Commitments and Cash Outlays (Dollars in millions)	Commitments December 31, 2006	Commitments December 31, 2005	Cash Outlays December 31, 2006	Cash Outlays December 31, 2005
Construction and Building Purchase	$ 13	$ 15	$ 53	$ 48
Building Improvements	60	78	155	109
Mail Processing Equipment	49	54	216	230
Vehicles	-	4	9	50
Postal Support Equipment	44	2	51	133
Total	$ 166	$ 153	$ 484	$ 570

EXPENSE COMMITMENTS AND RESOURCES ON ORDER

The change in our expense commitments at December 31, 2006 was a net increase of $317 million over the September 30, 2006 resources on order. This compares to an increase in December 31, 2005 over September 2005 of $200 million. Typically, we tend to see an increase in the first quarter as new contracts tend to take effect at the beginning of a fiscal year.

Productivity

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

Quarter I TFP increased 1.9%, with the related workload increase of 1.5%, while resource usage decreased 0.4%. The Quarter I weighted mail volume increase of 1.2% was smaller than the total mail volume increase or 2.3% due to growth in low-cost Standard Mail Enhanced Carrier Route and Standard Mail Regular volume. The 0.4% decrease in resource usage was driven by 1.8% decrease in labor input. Labor input represents 78% of all resources used to produce TFP workload. The 1.9% Quarter I productivity increase is approximately equivalent to an expense reduction of $348 million.

Service and Performance

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

EXFC

The External First-Class Mail measurement system (EXFC) is an independently administered system that provides an external measure of collection box to mailbox delivery performance. Although not a system-wide measurement of all First-Class Mail performance, EXFC continuously tests a panel of 463 3-digit ZIP Code areas selected on the basis of geographic and volume density, thereby providing a measure of service performance from the customer's point of view.

Our EXFC scores improved in all categories over Quarter I of 2006, with overnight delivery scores increasing from 94% to 95%, 2-day increasing from 88% to 91% and 3-day scores increasing from 83% to 86%.

CUSTOMER SATISFACTION

CSM is an independently administered survey of customer opinions of key areas of service to customers. Customer satisfaction has remained constant from Quarter I of 2006 at 92%.

Rate and Classification Activity

On May 3, 2006, the Postal Service filed a request with the PRC to increase prices by an average of 8.5%. This request is not across-the–board, but is intended to align our prices with our costs. The filing also includes numerous innovative classification proposals. The most sweeping of these classification proposals is more extensive shape-based pricing. The last rate case of this nature was in 2001. The filing also contains a proposal for a stamp that would be sold at the prevailing First-Class Mail single-piece letter rate. Consumers would be able to use this stamp for the prevailing First-Class single-piece rate forever. Other proposals are designed to reduce "undeliverable as addressed" First-Class Mail, improve the handling of Periodicals and enhance our insurance offerings. The PRC has ten months from the filing date to submit its findings to the Board of Governors for its review.

Outlook

The outlook for the remainder of 2007 continues to be challenging. Revenue growth for the remainder of the year will be impacted by the May 2007 rate increase and slow economic growth.

REVENUE OUTLOOK

The long-predicted slowdown in macroeconomic growth arrived in 2006 and is expected to continue into Quarter II of 2007. Economic growth is expected to pick up slightly in Quarter III and Quarter IV. If the economy rebounds strongly from the effects of the slump in the residential housing market and if energy prices stay under control, the economy may out perform expectations. The anticipated 8.5% rate increase in May should continue to act to depress mail volume growth for the last five months of the fiscal 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 as measured by real Gross Domestic Product (GDP) in 2006 averaged 3.3%. Growth slowed to 2.4% in Quarter I. According to Global Insight, real GDP growth is expected to slow further to about 2% in Quarter II before rebounding slightly and finishing the year at 2.6%. 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 grew about 1.1% in 2006. In Quarter I employment grew 1.4%. Growth is expected to slow to 0.9% for the remainder of 2007. Real retail sales, a driver of both advertising mail and packages, are expected to grow 1.4% for the remainder of 2007, after growing 3.4% in Quarter I. Real Investment spending, which is correlated with advertising expenditures, declined 0.9% in Quarter I and is expected to decline 2.5% for the reminder of 2007. This growth rate reflects the drag of residential investment on overall investment spending.

Trends in the macro economy are expected to be dominated by major factors in 2007. Volatility in energy prices has made forecasting economic growth and inflation challenging. Investment spending in the residential housing sector is expected to rebound eventually, but the rebound is not expected until Quarter II of fiscal year 2008. These two events may both reflect and affect the actions of the Federal Reserve with regard to interest rates. Unfortunately the slowdown in the economy coincides with an 8.5% average rate increase. Although this increase should generate significant additional revenue, it could suppress volume growth well into 2008.

Revenue growth is needed to support our ever expanding delivery network. 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 billion to cover institutional costs annually, about 28% of the total contribution. As this mail volume falls, other lower margin products must grow at ever-increasing rates in order to replace the lost 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.

Long-term, we will no longer be holding funds in escrow; consequently we will no longer have the interest earnings on the escrow account. The reduction of interest income will be over $100 million per year.

EXPENSE OUTLOOK

With the Quarter I decline in work hour usage, we are on track to reduce work hours for seventh year out of the last eight. Additionally, the stabilization of fuel prices has temporarily stemmed the upward pressure of fuel related costs.

For the remainder of 2007, the passage of The Postal Accountability Enhancement Act, P.L.109-435, will place additional upward pressure on our expenses. The Postal Retiree Health Benefits Fund will add another approximately $4 billion of expense for the remainder of the year, which will be partially offset by the elimination of the 17.4% CSRS contribution and the supplemental liability payment. These reductions total approximately $1.1 billion leaving a net increase in expenses of over $950 million per quarter.

Long-term, P.L.109-435 will continue to place additional upward pressure on our expenses as we incur costs relating to Sarbanes-Oxley compliance, system changes that may be needed to support segregation of competitive and market dominant business lines, required SEC-style financial reporting and other costs associated with the new law.

The exact cost of complying with section 404 of the Sarbanes-Oxley Act is not yet known. Our external auditor's professional fees will also increase in order for us to comply with the requirements under this act, as well as with our requirements to file SEC 10Q, 10K and other reports with the PRC.
There may also be increased borrowing to cover the additional cash outlays which will increase our interest expense.

However, a decade from now, by 2017, we anticipate we will have fully funded all our retirement obligations and at that point our annual cash outlays for retiree health benefits will drop approximately $8 billion to $9 billion dollars.

The projected financial impacts of P.L.109-435 are reflected in the table:

Financial Impacts under P.L.109-435 (Dollars in billions)	Projected Total 2007
	(unaudited)
Net Income per Integrated Financial Plan	**$ 1,709**
P.L.109-435 Impacts:	
2006 escrow transferred into PSRHBF	**(2,958)**
2007 PSRHBF expense	**(5,400)**
CSRS savings	**1,482**
Net Loss	**$ (5,167)**

Pending Legislation

AVIATION SECURITY

On January 5, Rep. Benny Thomson (D-MS), Chairman of the House Homeland Security Committee, introduced House Resolution 1 (H.R.1), *Implementing the 9/11 Commission Recommendations Act of 2007* which is a Democratic leadership priority. H.R.1 would give the Department of Homeland Security three years to phase in complete screening for all cargo on passenger aircraft. The screening program would be required to use equipment, technology, and personnel to inspect cargo that, at a minimum, provide a level of security equivalent to the level of security for the inspection of passenger checked baggage. If this provision were to pass, it could cause a substantial impact on the performance and costs of transportation of mail by air because the screening equipment used for checked baggage has a slower processing speed compared to current mail processing equipment, and such screening could raise costs substantially. The House passed H.R.1 by 299-128 vote on January 9. The bill has been referred to the Senate Homeland Security and Governmental Affairs Committee for further consideration.

ENERGY

On January 4, 2007, Senator Tom Harkin (D-IA) introduced Senate 23 (S.23), the *Biofuels Security Act of 2007*, which is intended to increase the availability of alternative fuels and alternative fuel vehicles. The bill would require 100% of vehicle acquisitions by federal fleets to be alternative fuel vehicles in 2008 and thereafter. Postal Service legal and energy staffs are examining this provision to determine its precise impact. The bill would require vehicle manufacturers to increase the fraction of dual-fuel vehicles from 10% of their fleets in 2008 up to 100% in 2017 and beyond. S.23 has been referred to the Senate Commerce Committee.

P.L.108-18

Portions of The Postal Civil Service Retirement System Funding Reform Act of 2003 P.L.108-18 have been superseded by the President's signing of The Postal Accountability and Enhancement Act, P.L.109-435. See Note 2, *Public Law 109-435 Postal Accountability and Enhancement Act,* in Part I of the Financial Information.

Item 3 – Quantitative and Qualitative Disclosures about Market Risk

In the normal course of business, we are exposed to market risks from changes in commodity prices, certain foreign currency exchange rate fluctuations, and interest rates. Our commodity price risk is primarily exposure to changes in prices for diesel fuel, unleaded gasoline and aircraft fuel for transportation of the mail, and fuel for heating facilities. We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations 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.

See Item 7A-*Quantitative and Qualitative Disclosures about Market Risk* in our 2006 Annual Report.

Item 4 – Controls and Procedures

We maintain a system of internal control 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 monitor our internal controls over financial reporting, disclosure controls and procedures through internal self-assessments.

Based on our evaluation, we concluded that our controls over financial reporting and disclosure controls were effective as of December 31, 2006. There have been no material changes during Quarter I of 2007.

With the passage of P.L.109-435, the Postal Service must comply with section 404 of the requirements of the Sarbanes-Oxley Act of 2002 by September 30, 2010.

Part II Other Information

Item 1 – Legal proceedings

Our contingent liability and related expense increased by approximately $16 million during the first quarter of 2007. See Note 8, *Contingent Liabilities*, in our 2006 Annual Report.

Item 1A – Risk Factors

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities. Therefore, we have no risk related to initial stock offerings.

Item 2 – Unregistered Sales

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities.

Item 3 – Defaults on Securities

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities.

Item 4 – Submission of Matters to a Vote of Security Holders

Not applicable to the United States Postal Service. As an "independent establishment of the executive branch of the United States government", we do not issue stock or related securities.

Item 5 – Other information

Labor Agreements

Because our workforce is heavily unionized, our costs are largely determined by the provisions of existing labor agreements. Labor agreements with our four major unions expired during Quarter I of 2007. As of the date of this report, we had reached agreements with two of our four major unions.

In January, the American Postal Workers Union (APWU) ratified a new contract with the Postal Service. The new contract will remain in effect through November 20, 2010. Highlights of the agreement include:

- Semi-annual cost-of-living adjustments (COLAs) will continue for the duration of the contract
- November 25, 2006 – 1.3% salary increase
- February 16, 2008 – eligible members will receive a one-level upgrade in position
- November 21, 2009 – 1.2% salary increase

In January, the National Postal Mail Handlers Union (NPMHU) ratified a new contract with the Postal Service. The new contract will remain in effect through November 20, 2011. Highlights of the agreement include:

- Semi-annual cost-of-living adjustments (COLAs) will continue for the duration of the contract
- General Salary increases of 1.2% in November each year
- February 16, 2008 – 0.6% salary increase

The National Rural Letter Carriers (NRLC) union members rejected the tentative agreement reached in December 2006. We will now meet with union officials to decide how to proceed.

We have not reached an agreement with The National Association of Letter Carriers and have entered into the dispute resolution process.

Other Financial Information

Other financial information such as *Annual and Quarterly* reports, *Comprehensive Statements on Postal Operations* and *Revenue, Pieces and Weight* reports can be obtained at http://www.usps.com/financials/

Press Releases

The following are press releases relevant to events discussed in this report. The full text of these releases can be obtained at http://www.usps.com/communications/news/press/welcome.htm.

February 7, 2007 - News Release #07-011
Rural Letter Carriers' Union Members Reject Tentative Contract

February 5, 2007 - News Release #07-010
Postal Service Again Honored As Most Trusted Government Agency

January 25, 2007 - News Release #07-008
Mail Handlers Union Members Approve Five-Year Contract

January 16, 2007 - News Release #07-005
Postal Workers Union Members Approve Four-Year Contract

January 10, 2007 - News Release #07-003
Postal Service Board Of Governors Authorizes Purchase Of 5,856 Delivery Vehicles

January 4, 2007 - For Immediate Release
Comment on President's signing statement accompanying Postal Accountability and Enhancement Act

December 20, 2006 - News Release #06-089
President Bush Signs New Postal Law

December 13, 2006 - News Release #06-085
Postal Service and National Postal Mail Handlers Union Reach Tentative Contract Agreement

December 9, 2006 - For Immediate Release
Statement of Postmaster General John E. Potter: Passage of the Postal Accountability and Enhancement Act

December 8, 2006 - News Release #06-083
Postal Service and National Rural Letters Carriers' Association Reach Tentative Contract Agreement

December 6, 2006 - News Release #06-081
USPS Expands Mail-Sorting Technology To Improve Service, Reduce Costs

December 6, 2006 - News Release #06-080
Postal Service and APWU Reach Tentative Contract Agreement

November 15, 2006 - News Release #06-073
Postal Service Ends Year With Record Revenue But High Fuel Costs Boost Expenses

Item 6 – Exhibits

None