United States Postal Service
475 L'Enfant Plaza, SW
Washington, DC 20260

202-268-2000
www.usps.com

Quarterly Financial Report

For the Three Months Ended December 31, 2004

February 18, 2005

Part I. Financial Information

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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 December 31,	
	2004 (unaudited)	2003 (unaudited)
Operating revenue	**$ 18,786**	$ 18,209
Operating expenses:		
Compensation and benefits	**13,641**	13,130
Transportation	**1,419**	1,177
Other	**1,999**	2,084
Total operating expenses	**17,059**	16,391
Income from operations	**1,727**	1,818
Interest and investment income	**11**	8
Interest expense	**(56)**	(9)
Net Income	**$ 1,682**	$ 1,817

See accompanying notes to financial statements.

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

	December 31, 2004 (unaudited)	September 30, 2004
Assets		
Current assets:		
Cash and cash equivalents	**$ 737**	$ 877
Receivables:		
Foreign countries	**676**	621
U.S. government	**296**	327
Other	**242**	187
Receivables before allowances	**1,214**	1,135
Less allowances	**114**	111
Total receivables, net	**1,100**	1,024
Supplies, advances and prepayments	**178**	220
Total current assets	**2,015**	2,121
Other assets, principally revenue forgone appropriations receivable	**361**	361
Property and equipment, at cost:		
Buildings	**20,220**	20,171
Equipment	**17,592**	17,277
Land	**2,809**	2,810
Leasehold Improvements	**1,108**	1,103
	41,729	41,361
Less allowances for depreciation and amortization	**21,116**	20,656
	20,613	20,705
Construction in progress	**1,955**	1,792
Total property and equipment, net	**22,568**	22,497
Total Assets	**$ 24,944**	$ 24,979

See accompanying notes to financial statements.

United States Postal Service

Balance Sheets - Liabilities & Net Capital

(dollars in millions)

	December 31, 2004 (unaudited)	September 30, 2004
Liabilities and Net Capital		
Current liabilities:		
Compensation and benefits	**$ 2,336**	$ 2,640
Estimated prepaid postage	**1,244**	1,256
Payables and accrued expenses:		
Commercial Vendors and accrued expenses	**1,502**	1,739
Foreign countries	**825**	778
U.S. Government	**68**	87
Total payables and accrued expenses	**2,395**	2,604
Customer deposit accounts	**1,765**	1,606
Outstanding postal money orders	**786**	767
Prepaid box rent and other deferred revenue	**389**	397
Debt	**-**	1,800
Total current liabilities	**8,915**	11,070
Non-current liabilities:		
Workers' compensation	**6,963**	6,651
Employees' accumulated leave	**2,132**	2,006
Other	**1,321**	1,321
Total non-current liabilities	**10,416**	9,978
Total Liabilities	**19,331**	21,048
Net capital:		
Capital contributions of the U.S. government	**3,034**	3,034
Retained earnings since reorganization	**2,579**	897
Total Net Capital	**5,613**	3,931
Total Liabilities and Net Capital	**$ 24,944**	$ 24,979

See accompanying notes to financial statements.

United States Postal Service
Statements of Changes in Net Capital
Three months ended December 31, 2004 and the year ended Sept. 30, 2004
(dollars in millions)

	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital
Balance, Sept. 30, 2003	$ 3,034	$ (2,168)	$ 866
Net Income		3,065	3,065
Balance, Sept. 30, 2004	3,034	897	3,931
Net Income–Three Months Ended December 31, 2004 (unaudited)		1,682	1,682
Balance, December 31, 2004 (unaudited)	**$ 3,034**	**$ 2,579**	**$ 5,613**

See accompanying notes to financial statements.

United States Postal Service
Statements of Cash flows

(dollars in millions)

	Three Months Ended December 31, 2004 (unaudited)	Three Months Ended December 31, 2003 (unaudited)
Cash flows from operating activities:		
Net Income	$ 1,682	$ 1,817
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	499	566
Loss on disposals of property and equipment, net	4	8
Increase in USPS workers' compensation liability	312	349
Increase in employees' accumulated leave	126	69
Decrease in other liabilities	-	(18)
Changes in current assets and liabilities:		
Increase in receivables, net	(76)	(61)
Decrease in supplies, advances and prepayments	42	22
(Decrease) increase in compensation and benefits	(304)	567
Decrease in estimated prepaid postage	(12)	-
(Decrease) increase in payables and accrued expenses	(209)	330
Increase in customers deposits	159	24
Increase in outstanding postal money orders	19	3
(Decrease) increase in Prepaid box rent and other deferred revenue	(8)	24
Net cash provided by operating activities	2,234	3,700
Cash flows from investing activities:		
Purchase of property and equipment	**(576)**	(387)
Proceeds from sale of property and equipment	**2**	3
Net cash used in investing activities	**(574)**	(384)
Cash flows from financing activities:		
Payments on debt	**(1,800)**	(5,023)
Net cash used in financing activities	**(1,800)**	(5,023)
Net decrease in cash and cash equivalents	**(140)**	(1,707)
Cash and cash equivalents at beginning of year	**877**	2,266
Cash and cash equivalents at end of period	**$ 737**	$ 559
Supplemental Data		
Cash paid during the year for Interest	**$ 0**	$ 7

See accompanying notes to financial statements.

Notes to Financial Statements

Note 1. Basis of Presentation
This interim report reflects the operations of the United States Postal Service for the three months ended December 31, 2004 and December 31, 2003. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and should be read in conjunction with the significant accounting policies and other disclosures in our 2004 Annual Report. The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and judgments that affect the amounts reported in the financial statements and accompanying notes. The accounting estimates that require management's most difficult and subjective judgments include: our workers' compensation liability, estimated prepaid postage, and the contingent liabilities. The Civil Service Retirement System "supplemental liability" represents an additional substantial estimate that is calculated by the Office of Personnel Management (OPM). The actual results experienced may differ from estimates.

In the opinion of management, the accompanying unaudited financial statements present fairly our financial position as of December 31, 2004, the results of our operations for the three months ended December 31, 2004, and our cash flows for the three months ended December 31, 2004.

Note 2. Retirement Programs
We account for our involvement in our retirement program as participation in a multiemployer plan arrangement in accordance with FAS 87, *Employers' Accounting for Pension Costs*. Therefore, the costs of these benefits are expensed as we incur them. We provide pension benefits as defined by OPM and have a parent-subsidiary type relationship with the United States government. As a subsidiary we cannot direct the costs, benefits or funding requirements of the federally-sponsored plans.

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

Note 3. Retiree Health Benefits
We are required to pay a portion of the health insurance premiums of those retirees and their survivors who participate in the Federal Employees Health Benefits Program (FEHBP). We account for our involvement in FEHBP as participation in a multiemployer plan arrangement in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Therefore, the costs of these benefits are expensed as we incur them.

Note 4. Emergency Preparedness Funding
In December, 2004, an appropriation of $503 million was provided by Congress for additional Biohazard Detection Systems, Ventilation Filtration Systems, and an irradiation facility. These funds will be recognized as revenue as the capital equipment that is purchased with the appropriation is depreciated. During Quarter 1, we recorded $2 million of depreciation expense and associated appropriations revenue. Other costs of mail security and employee protection, such as maintenance and consumable supplies, are being funded internally.

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

Capital
At December 31, 2004, we estimate our financial commitment (resources on order) for approved capital projects in process to be $2.6 billion.

Rents
At December 31, 2004, our future minimum lease payments for all non-cancelable leases are as follows:

Future Minimum Lease Payments		
($ in millions)	**December 31, 2004**	
Year	**Operating**	**Capital**
2005	**$ 630**	**$ 56**
2006	**810**	**74**
2007	**777**	**74**
2008	**730**	**74**
2009	**674**	**74**
After 2009	**5,951**	**562**
	$ 9,572	**914**
Less: Interest		**230**
Total Capital Lease Obligations		**684**
Less: Short-term Portion of Capital Lease Obligations		**34**
Long-term Portion of Capital Lease Obligations		**$ 650**

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 $845 million at December 31, 2004 and $847 million at September 30, 2004. Total accumulated amortization related to capital leases was $270 million at December 31, 2004 and $259 million at September 30, 2004. Amortization expense for capital lease assets is recorded as depreciation expense.

Note 6. Contingent Liabilities
Each quarter we review pending litigation against us. We classify and adjust our contingencies for claims when we can reasonably estimate the amount of a probable, unfavorable outcome. These relate to labor claims, equal employment opportunity claims, environmental matters, traffic accidents, injuries sustained on postal properties, personal claims, claims for property damages and suits and claims arising from postal contracts. Additionally we evaluate the materiality of cases determined to have a reasonable chance of adverse outcome. Such cases are immaterial to our financial statements taken as a whole. Management and General Counsel believe that we have made adequate provision for the amounts that may become due under the suits, claims and proceedings we have discussed here.

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

Cautionary Statements

The "Management's Discussion and Analysis of Results of Operations and Financial Condition" and other parts of this report include statements representing our expectations about our business and financial results that may be affected by risks and uncertainties we discuss here and in our Annual Report, such as economic conditions, regulatory and legislative changes, trends we know about, trends we anticipate, and trends we believe are relevant to future operations. Some of these factors may cause our actual results to differ materially from those contemplated. This report should be read in conjunction with our 2004 Annual Report.

Introduction

The Postal Service (we) commenced operations on July 1, 1971 as an independent entity of the executive branch of the United States government. Under the Postal Reorganization Act, we have a legal mandate to offer a "fundamental service" to the American people on a "fair and equitable basis."

Our primary lines of business are First-Class Mail, Standard Mail, Priority Mail, Express Mail, Periodicals and Package Services. The Postal Service serves 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 postal services are subject to a regulatory review process controlled by the independent Postal Rate Commission.

Our products are distributed through our more than 37,000 Post Offices, Stations and Branches and a large network of consignees. Mail is delivered to 142 million city, rural, post office box and highway contract delivery points. We conduct our significant operations primarily in the domestic market, with international operations representing less than 3 percent of our total revenue.

The Postal Service operates and manages integrated retail, distribution, transportation and delivery networks. As such, its physical infrastructure and its labor force are not dedicated to individual products or separate product lines, with limited exception. 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 the Postal Service.

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

Our labor force is primarily represented by the American Postal Workers Union, the National Association of Letter Carriers, the National Postal Mail Handlers Union and the National Rural Letter Carriers Association. Approximately 90 percent of our career employees are covered by collective bargaining agreements. By law, we consult with management organizations representing most of the employees not covered by collective bargaining agreements. The management organizations include the National Association of Postal Supervisors, the National League of Postmasters, and the National Association of Postmasters of the United States. As an independent entity of the executive branch of the United States government, we participate in federal employee benefit programs covering retirement, health benefits and workers' compensation.

We are not subject to regulation by the Securities and Exchange Commission (SEC). However, we comply voluntarily with Securities and Exchange Commission financial reporting requirements to the extent that they reasonably may be applied to a non-publicly traded, government-owned entity with a breakeven mandate. Therefore, this report excludes certain SEC reporting elements normally included in Part II – Other Information of a standard Form 10-Q. Specifically, the excluded items are: Item 2 - Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities; Item 3 - Defaults upon Senior Securities; and Item 4 - Submission of Matters to a Vote of Security Holders.

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

Results of Operations

Operating revenue in the first quarter was $18,786 million, compared to $18,209 million in the corresponding quarter last year. Volume and revenue increased for all mail classes except Package Services. Overall for the quarter, mail volume increased by 5.5 percent, primarily driven by a strengthening economy, a surge in credit card solicitations, and election year mailings.

For the quarter, operating expenses grew by 4.1 percent. Compensation and benefits expense, driven by wage, benefit and workload increases, contributed to most of the increase over the same quarter last year. Depreciation expenses declined modestly due to reductions in capital expenditures in previous years and supplies and services declined slightly as well. Transportation expenses, driven by higher jet fuel and gasoline prices, increased volume, and higher international mail settlement costs contributed to the remaining expense growth. However, improved productivity helped to offset some of the cost increases.

The combined effect of these factors is a first quarter operating income of $1,727 million, which is $91 million less than the same period last year. Net Income for the quarter was $1,682 million, compared to $1,817 million in the same quarter last year.

Table 1 – Summary of Interim Financial Results provides the financial results for the three months ended December 31, 2004 with the comparable results for same period in 2003.

Table 1 – Summary of Interim Financial Results

Financial Results	Three Months Ended December 31,		
($ in millions)	2004	2003	% change
Operating revenue	$18,786	$18,209	3.2
Operating expense:			
Compensation and benefits	13,641	13,130	3.9
Transportation	1,419	1,177	20.5
Supplies and Services	477	515	-7.3
Depreciation and amortization	499	566	-11.8
Other Expenses	1,023	1,003	2.0
Total operating expense	17,059	16,391	4.1
Income from operations	1,727	1,818	NM
Interest and investment income	11	8	29.1
Interest expense on borrowings	-2	-9	83.3
Deferred Retirement Interest	-54	0	NM
Net income	$1,682	$1,817	NM

Note: Percentages are calculated based on unrounded numbers.

Operating Revenue

Operating revenue was 3.2 percent higher for the three months ended December 31, 2004 than for the same three months in the previous year. Total volumes in the quarter were 5.5 percent above last year, primarily due to 2.3 billion additional pieces of standard mail. Volume and revenue were up across all major classes, except for package services.

A number of factors aligned to generate strong revenue and volume growth in Quarter 1, including solid economic growth, strengthening direct marketing channels, the quadrennial impact of election mailings, increased activity in marketing financial services and credit cards and a calendar shift that added two days to the holiday marketing and mailing season between Thanksgiving and Christmas. Quarter 1 also had one more non-holiday weekday than last year, and one less non-holiday Saturday. Because weekday revenues are significantly larger than Saturday revenues, this calendar shift had a net positive affect on revenue.

Total Standard Mail volume exceeded total First-Class Mail volume for the second straight quarter, sustaining a reversal in the historical relationship where First-Class Mail volume had always exceeded Standard Mail volume.

In Quarter 1, single piece First-Class letter volume continued its long-term decline, reflecting the ongoing impact of electronic diversion. However, workshare First-Class letter volume increased sharply (up 7.1 percent, the largest quarterly growth since 1995), after stagnating over the last two years. The financial services sector is a major user of workshared First-Class Mail to market its services. We believe major increases in credit card marketing precipitated workshare volume growth.

Priority Mail and Express Mail experienced positive growth, reflecting the impact of rate stability and the benefit of continued economic growth. Periodical volume and revenue also grew slightly, reflecting the strengthened economy and growing advertising markets.

Standard Mail volume growth was aided considerably by the impact of the quadrennial election cycle, as well as being driven by the increasing strength of direct marketing channels and surges in credit card marketing. Package services volume was down, as increases in Bound Printed Matter volume were insufficient to overcome declines in Parcel Post, Media Mail and Library Mail volumes. Other volume grew primarily due to Postal Service initiatives to re-connect with its customers during the holiday mailing season, including nationwide distribution of the Holiday Mailing Guide.

Table 2 – Volume by Class of Mail

Volume	Three Months Ended December 31,		
(millions of pieces)	2004	2003	% change
First-Class Mail	26,428.2	25,887.7	2.1
Priority Mail	239.6	233.9	2.4
Express Mail	13.5	13.4	0.6
Periodical Mail	2,340.2	2,316.2	1.0
Standard Mail	26,954.4	24,663.7	9.3
Package Services	314.7	319.1	-1.4
Other	468.4	386.0	21.3
Total Mail Volume	56,759.0	53,820.0	5.5

Note: Percentages are calculated based on unrounded numbers.

Volume grew for all major classes except Package Services. Standard volume grew by 2.3 billion pieces compared to the prior year. First-Class volume grew by 0.5 billion pieces. Total volume increased by 2.9 billion pieces or 5.5 percent.

Table 3 – Revenue by Class of Mail

Revenue	Three Months Ended December 31,		
($ millions)	2004	2003	% change
First-Class Mail	$ 9,748.0	$ 9,661.6	0.9
Priority Mail	1,294.0	1,272.5	1.7
Express Mail	217.5	216.9	0.3
Periodicals Mail	563.5	562.0	0.3
Standard Mail	5,053.9	4686.0	7.9
Package Services	646.0	658.9	-2.0
Other	1,263.1	1,151.1	9.7
Total Operating Revenue	$18,786.0	$18,209.0	3.2

Note: Percentages are calculated based on unrounded numbers.

Revenue also increased for all major classes except Package Services. Major increases in "Other Revenue" are primarily attributable to increased International Mail revenue and criminal forfeitures taken into revenue during Quarter 1. Total operating revenue grew by 3.2 percent.

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

Operating Expenses and Workhours

Compensation and Benefits

Compensation and Benefits costs for Quarter 1 were $13,641 million, or 3.9 percent higher than the prior year period. This increase was driven by wage, benefit and workload increases, as described in detail below, which contributed to workhour growth of 0.7 percent. In addition, contractual wage increases, cost-of-living increases, and higher benefits expenses all contributed to higher compensation and benefits expenses. Significant components of benefits include retiree health benefits, worker's compensation, and retirement expenses. These components are also reviewed in this section.

Workhour usage is impacted by a change in workload, a change in productivity, or both. The two major workload factors that impact postal operations are changes in mail volume and changes in possible deliveries. In our first quarter, mail volume increased by 2.9 billion pieces, or 5.5 percent, and we added 1.8 million new possible deliveries, as compared to the same quarter last year. This workload increase would, without productivity improvement, have required the equivalent of 4.5 million additional workhours. Continued cost control kept the increase to only 2.6 million workhours, or 0.7 percent over the comparable period last year.

Workhour savings were achieved through the implementation of plans to continue productivity increases and control expense growth using both cost savings programs and improvements in operational efficiencies. The majority of our savings continue to come from increases in operational efficiency. Total possible deliveries continue to grow at a consistent rate of about 1.8 million deliveries per year, resulting in a combined rural delivery and city delivery increase of 4.8 million hours over the same quarter last year. The volume related workload impact in just the delivery function is equivalent to 2.7 million workhours.

Table 4 – Workhours by Function summarizes the workhour utilization for Quarter 1 of fiscal year 2005 compared with the same quarter last year.

Table 4 - Workhours by Function

Workhours	Three Months Ended December 31		
(Thousands)	2004	2003	% change
Operations			
-Operations Support	2,239	2,215	1.1
-Mail Processing	90,276	90,739	-0.5
-Rural Delivery	44,727	42,304	5.7
-City Delivery	119,895	117,557	2.0
-Vehicles Services	8,134	8,146	-0.2
-Plant & Equip Maintenance	20,307	20,570	-1.3
-Customer Services	60,520	59,636	1.5
Postmasters & Installation Heads, Administration and Other	29,729	32,103	-7.4
Total Workhours	375,827	373,270	0.7

Note: Percentages are calculated based on unrounded numbers.

The paragraphs below discuss the changes in workhours by function. These workhour changes have a direct impact on expenses by function.

Operations Support consists of supervisory, administrative and clerical hours in support of mail processing, delivery and retail operations. Operations Support activities assist field operations in optimizing efficiency. To support the increased volume for this year's fall mailing season, Operations Support work hours were slightly higher than last year.

Mail Processing includes workhours for manual, mechanized and automated distribution of the mail. Continued productivity increases using both cost savings programs and improved operational efficiencies resulted in continued workhour declines in Mail Processing. Workhours in the mail processing function declined by 0.5 million workhours compared to the comparable quarter last year.

Rural and City Delivery functions include delivery and collection of mail, carrier office and street activities, supervisory support, and training. The growth in total possible deliveries at a consistent rate of about 1.8 million deliveries per year, resulted in a combined rural and city delivery increase of 4.8 million hours over the same quarter last year. As rural deliveries grow at a faster rate than city deliveries, the relative change in rural delivery is higher than in city delivery. The volume related workload impact in the delivery function is equivalent to 2.7 million workhours. Most of the remaining workhour growth is attributable to expansion of the delivery network.

Vehicle Services includes hours for operating and maintaining the postal vehicle fleet and support hours for stockroom duties and vehicle accident investigations. The 0.2 percent decrease in Vehicle Service hours is attributable to a reduction in supervisory and administrative hours required to manage vehicle operations.

Plant and Equipment Maintenance includes hours for maintaining mail handling equipment, building maintenance and custodial activities. The decrease in Plant and Equipment Maintenance hours is driven by a reduction in custodial hours.

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

Postmasters and Installation Heads, Administration, and Other covers all remaining functions, including support activities involving information systems, finance, human resources, marketing and sales at all locations. This category also includes employees on limited duty and rehabilitation. In 2004, we began an effort to change in how we track workhours for employees in limited duty or rehabilitation assignments. The workhours for limited duty and rehabilitation employees are now included in their functional areas as we attempt to return these employees to full duty. Limited duty and rehabilitation workhours have decreased by more than 1 million compared to the same quarter last year.

Despite the increase in workload and workhours, employee complement decreased in Quarter 1. The number of career employees, not including the Office of the Inspector General (OIG), was reduced 1,340 during the quarter through attrition. The pace of complement reductions slowed during the quarter, compared to recent quarters. We anticipate that complement reductions will increase in Quarter 2, though the annual complement reduction for 2005 will likely be less than recent years.

The additional workhours required to service the higher workload experienced during Quarter 1 were provided through increased use of overtime. Overtime is a cost-effective method of handling transitory increases in workload such as typically encountered during this quarter. During Quarter 1, overtime hours increased by 5.2 million hours while straight time hours decreased by 2.6 million hours.

The cost of workhour changes, overtime, wage rate and COLA increases and benefits for current employees are reflected in the expenses associated with each function. Also included in the expenses for each functional category are the costs of contributions to the federal retirement programs for our career employees.

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

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

Beginning October 1, 2004, the employer contribution for the Federal Employee Retirement System (FERS) changed from 10.7 percent to 11.2 percent. This had the impact of increasing retirement expense for this component of retirement by $28 million dollars for the quarter.

The implementation of P.L.108-18 in May 2003 did not alter the fact that retirement expenses remain a significant portion of our total expenses. Retirement contributions for current employees, which are included in compensation and benefits expense, represented 10.4 percent of our total expenses during the first quarter. They increased by $45 million (inclusive of the FERS contribution rate change) when compared to Quarter 1 of 2004, when these benefits represented 10.5 percent of total expenses.

Table 5 –Compensation and Benefits Expense by Function, summarizes personnel compensation cost and compares the quarter ending December 31, 2004 compensation cost to that of the same period in 2003. The costs of retiree health benefits and workers' compensation are reflected as separate components of compensation and benefits expense.

Table 5 – Compensation and Benefits Expense by Function

Compensation and Benefits	Three Months Ended December 31,		
($ millions)	2004	2003	% change
Operations:			
-Operations Support	$ 98	$ 92	6.5
-Mail Processing	2,996	2,919	2.7
-Rural Delivery	1,257	1,159	8.5
-City Delivery	4,231	3,976	6.4
-Vehicles Services	302	288	4.8
-Plant & Equip Maintenance	751	720	4.4
-Customer Services, Retail & Sales	2,060	1,961	5.1
Postmasters & Installation Heads, Administration and Other	1,208	1,262	-4.2
Workers' Compensation	324	372	-13.1
Retiree Health Benefits	354	330	7.0
Other Personnel Compensation	60	51	19.3
Total Personnel Compensation	$ 13,641	$ 13,130	3.9

Note: Percentages are calculated based on unrounded numbers.

Workers' Compensation costs represented approximately 2.4 percent of compensation and benefits expenses in Quarter 1. 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, etc. The primary drivers for our Workers' Compensation expense are the number of claims reported and cost per claim. Our expenses are subject to adjustment based on claims information provided by OWCP. In the first quarter we had $324 million in workers' compensation expense, which is $48 million less than last year's first quarter expense.

Retiree Health Benefits costs were about 2.6 percent of compensation and benefits expense in Quarter 1, Under the Federal Employees Health Benefits Program (FEHBP), the Office of Personnel Management (OPM) bills us for the cost of our retirees participating in the plan. The major drivers of Retiree Health Benefits expense are the number of participants on the rolls and premium costs of the plans they select. As of December 31, 2004, we had approximately 440,000 participants on the rolls, an increase of about 8,500 over the prior year. Our expense related to retiree health benefits was $354 million during this quarter, compared to $330 million in the first quarter of FY2004.

Transportation
Transportation expense of $1,419 million is $241 million, or 20.5 percent, over last year's first quarter expense of $1,177 million. Air transportation of $649 million was $143 million or 28.1 percent over same period last year and highway transportation of $679 million was $79 million or 13.1 percent over same period last year.

While overall volume was up, significantly higher fuel prices contributed to the increase in our transportation expense, and this rise in fuel prices is not offset by fuel surcharges to our customers. During the first quarter, the index by which the jet fuel costs for our dedicated air carrier are calculated increased 58 percent from the same quarter last year. This resulted in an increase in fuel costs for the dedicated air transportation alone of approximately $31 million. During the same time frame, weekly national retail gasoline prices increased an average of $ 0.428 per gallon from a year ago, with price increases ranging from a low week of $ 0.319 to a high of $0.499.

Air transportation expense was also impacted by the mail volume increase, which contributed to a $34 million increase in mail handling charges, and a $23 million increase in costs for dedicated aircraft for holiday transportation requirements. Additionally, international mail transportation which includes costs to deliver mail originating in the United States and destinating in another country (known as terminal dues), represented approximately $185 million for the first quarter, compared to approximately $115 million in the corresponding prior year quarter. Year to year fluctuations in terminal dues expenses are normal and are due to timing and amounts of settlements with foreign postal administrations.

Highway transportation was severely impacted by increased fuel charges ($92 million). Non fuel charges declined compared to the same quarter last year by $13 million. Volume is up in this category but was absorbed into excess capacity. Continued improvement of the logistics network has actually caused a decrease in miles driven from 1.7 billion miles in the same quarter last year to 1.6 billion miles in Quarter 1 of this year.

Supplies and Services
Supplies and services expenses of $477 million were $38 million or 7.3 percent less than last year's comparable quarter. This reduction was largely attributable to across the board management initiatives to control spending and the deferral of some planned spending to future months.

Depreciation and Amortization
Depreciation expenses of $499 million were $67 million or 11.8 percent less than last year's comparable quarter. This reduction is attributable to reductions in capital spending in previous years.

Other Expenses
The major components included in this category are vehicle maintenance services, rent, utilities, information technology and communications. Other expenses of $1,023 million were $20 million or 2.0 percent higher than last year's comparable quarter. This increase was largely attributable to vehicle maintenance services for the quarter, which are increasing as the fleet ages.

Interest Expense
Interest expense, excluding deferred retirement interest, decreased by $7 million compared to the same quarter last year which reflects our payoff of debt. Interest expense on CSRS deferred retirement obligation was $54 million and reflects OPM's calculation of this obligation at September 30, 2004. We had not accrued any interest on the supplemental obligation for the same quarter last year due to the fact the estimate from OPM, was not received until the fourth quarter of last year.

Productivity

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

Quarter 1 TFP related workload increased by 3.4 percent, while resource usage increased 0.6 percent, yielding a 2.8 percent increase in TFP. This productivity growth is equivalent to approximately $500 million in Quarter 1 expense reductions. TFP growth has been positive in twenty-one of the last twenty-two quarters. The Quarter 1 workload increase of 3.4 percent was driven primarily by mail volume growth and, to a lesser extent, the expanding delivery network as described previously. Resource usage increased this quarter and was driven by increases in materials usage, including transportation, and a modest increase in labor usage.

Financial Condition

Debt and Liquidity
As of December 31, 2004, we had no outstanding debt with the Federal Financing Bank. This represents a reduction of $1.8 billion from year-end 2004, and is $2.25 billion less than the same period last year. Cash and cash equivalents were $737 million, $140 million less than September 30, 2004.

The first quarter of our fiscal year typically produces strong cash flow. We used the net cash flow provided from our operating activities and some of the cash balance that we had entering our fiscal year to eliminate our debt outstanding after providing for capital investment.

We continue to maintain two credit lines with the U.S. Treasury's Federal Financing Bank. One credit line enables us to draw upon up to $3.4 billion with two days' notice; the other up to $600 million on the same business day the funds are requested. We do not anticipate any further borrowings on our credit lines until the end of the fiscal year. In September, we will have approximately $1.3 billion in lump sum payments for workers' compensation and retirement liabilities.

Capital Expenditures and Commitments
Capital commitments through the first quarter were $422 million compared to $212 million in FY2004.

During the first quarter, the Board of Governors approved funding for two capital projects: Intelligent Mail Data Acquisition System (IMDAS) – Mobile Data Collection Device Replacement, and additional Biohazard Detection Systems (BDS). The IMDAS scanners will replace all existing Mobile Data Collection Devices used by postal carriers and clerks. The BDS project provides additional funding which will permit completion of the purchase and installation of 1,705 BDS units in 282 mail processing facilities and support sites nationwide.

The capital cash outlays for Quarter 1 were $576 million in Fiscal Year 2005 compared with $387 million in FY2004. Table 7 – Capital Commitments, Expenditures, and Resources on Order, below, summarizes FY2005 activity Quarter 1 compared to the same quarter last year.

Table 7 – Capital Commitments, Expenditures, and Resources on Order

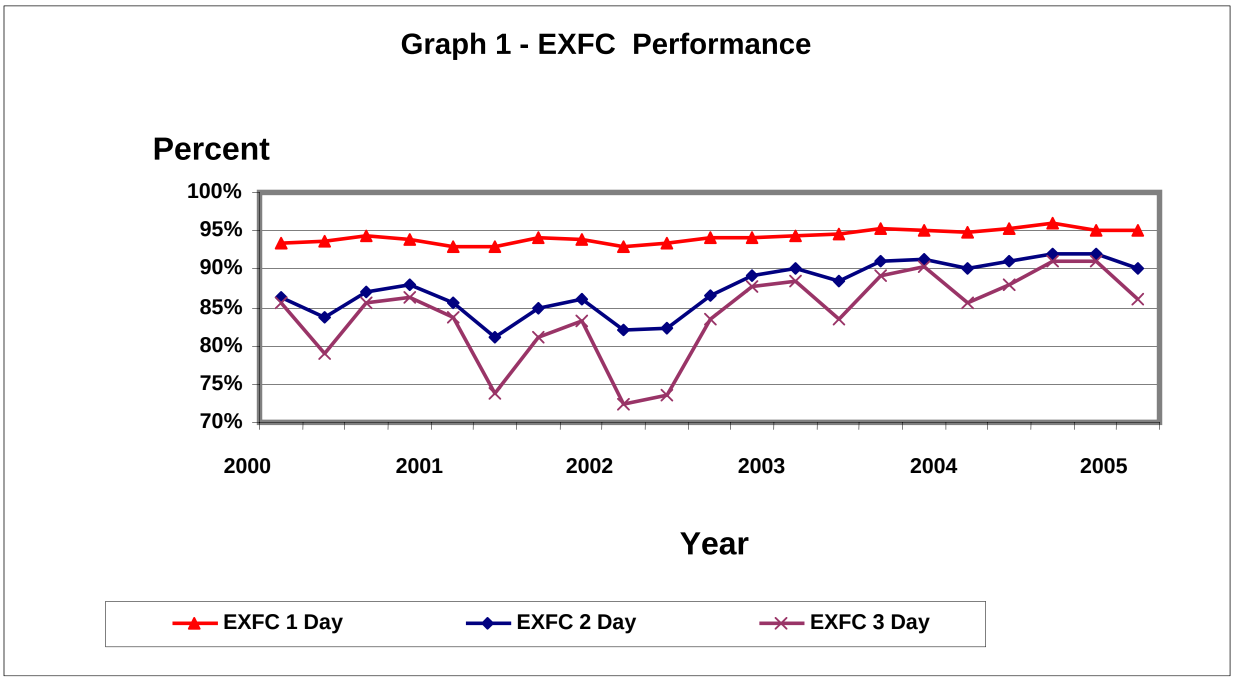
CAPITAL INVESTMENTS	COMMITMENTS [1]		CASH OUTLAYS		RESOURCES ON ORDER [2]	
($ millions)	Three months ended December 31,		Three months ended December 31,		December 31	September 30,
	2004	2003	2004	2003	2004	2004
CONSTRUCTION AND BUILDING PURCHASE	$31	$12	$61	$35	$160	$192
BUILDING IMPROVEMENTS	24	30	100	61	303	381
MAIL PROCESSING EQUIPMENT	1	-10	192	164	1,393	1,601
VEHICLES	1	130	53	33	68	126
RETAIL EQUIPMENT	2	26	40	18	57	95
POSTAL SUPPORT EQUIPMENT	363	24	130	76	632	414
TOTAL	$422	$212	$576	$387	$2,613	$2,809

[1] Capital Commitment - Binding agreements entered into by the Postal Service and vendors during the quarter for purchase of capital equipment, facilities, vehicles, or services, booked at the time the contract is signed.
[2] Resources on Order – All Capital Commitments that have not yet been paid.

Service and Performance

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

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



Graph 1 – EXFC Performance summarizes EXFC results by quarter since 2000. Even with the reductions in career employees and work hours, the Postal Service has maintained a high level of service for all categories. EXFC 2 and 3 day results declined modestly from the prior quarter but were consistent with the same quarter last year. This decline is generally associated with seasonal factors, such as localized severe weather and heavy holiday workload. This quarter is the fifth consecutive quarter for which we have achieved national EXFC 1 Day scores of 95 percent or above.

Customer Satisfaction
Independently measured customer satisfaction for residential household customers for Quarter 1 showed that 93 percent of these customers rated their experience with the Postal Service as “excellent”, “very good” or “good.” This is consistent with same quarter last year results of 93 percent as well.

Rate and Classification Activity

The Postal Rate Commission is an independent establishment of the executive branch of the United States government. The Commission reviews our proposals to establish and change domestic mail rates, fees and mail classifications. Upon request by the Postal Service, the Commission holds public hearings and issues recommended decisions to the Governors of the Postal Service, who approve, reject, or, in some cases, modify the Commission’s recommendations. The PRC is also authorized to issue advisory opinions concerning proposed changes in the nature of postal services that affect service on a nationwide or substantially nationwide basis, to recommend decisions regarding rate complaints by interested parties, and to report regarding complaints that parties are not receiving postal services in accordance with the policies of the Postal Reorganization Act. The PRC is also responsible for promulgating rules and regulations and establishing procedures deemed necessary and proper to carry out their functions and obligations.

The PRC recommended two new classifications and experiments during the Quarter.

On October 6, 2004, the Commission adopted a settlement proposed by the majority of the participants as the basis for its opinion and recommended decision approving a two-year experiment to test two box-shaped containers of standardized size for Priority Mail shipments. The Priority Mail Flat-Rate Boxes are available in two shapes: 11-7/8 inches x 3-3/8 inches x 13-5/8 inches (ideal for garments, board games, books and other relatively thin items) and 11 inches x 8-1/2 inches x 5-1/2 inches (perfect for shoes, model cars and taller items). Using Priority Mail Flat-Rate Boxes, customers will be able to mail domestic packages - regardless of the parcels' weight or destination - for just $7.70 each.

On December 10, 2004, the PRC recommended a market test establishing new classifications and rates for the attachment of Repositionable Notes (RPNs) on the covers of First-Class Mail, Standard Mail, and Periodicals. Repositionable note is a Post-it™ type self-adhesive note that mailers can affix to the outside of a mailpiece for fees ranging from $.005 to $.015 per piece depending on the classification of the mailpiece. Both recommendations were approved by the Board of Governors.

One classification case was pending at the end of this quarter. The case is the *Request of the United States Postal Service for a Recommended Decision on the Experimental Premium Forwarding Service, PRC Docket No. MC2005-1,* filed November 19, 2004. The experiment would establish a new classification and fee for the provision of Premium Forwarding Service (PFS), under which the Postal Service will reship all the mail of a customer who has temporarily relocated; such PFS shipments will be sent via Priority Mail® once a week to the customer’s temporary address.

Two requests for classifications, rates and fees to implement negotiated service agreements (NSA) functionally equivalent to the Capital One NSA, (PRC Docket No. *MC2002-2*) were recommended by the Commission. These were the Bank One Corporation (*PRC Docket No. MC2004-3*) and Discover Financial Services, Inc. (*PRC Docket No. MC2004-4*). Both agreements pertain to first class mail and first class mail solicitations for credit that bear the endorsement specified by the Postal Service. Both of these agreements create opportunities for the Postal Service to reduce costs and increase revenues by tailoring its mail services to the unique characteristics of its mailers.

There are three proposed rulemaking hearings in process. The first concerns defining the term “postal service”; the second involves new procedural rules concerning the information related to nonpostal products that will be required to be submitted as a part of a rate filing; and the third involves an expansion of the PRC’s administrative procedures to require additional, detailed periodic reporting. Five complaint cases are also open concerning removal of collection boxes, the Electronic Postmark, cost-based rates for Periodicals Mail, alleged service level changes, and sale of stamped stationary. Specific information on these pending dockets can be obtained at the PRC web site http://www.prc.gov.

Outlook

The outlook for the remainder of FY 2005 is positive. Financial results for the remainder of the year are not expected to rival the unexpectedly strong results in Quarter 1, primarily because several of the factors that drove Quarter 1's strong revenue growth are unlikely to continue. Expense growth is expected to be moderate, although continued high fuel prices remain a concern. Our net income for Quarter 1 was substantially better than we had planned entering the year. For the year, we had planned for a $200 million net loss. The positive results of Quarter 1 and our projections for the remainder of the year indicate that we will achieve net income in excess of $1 billion for the year.

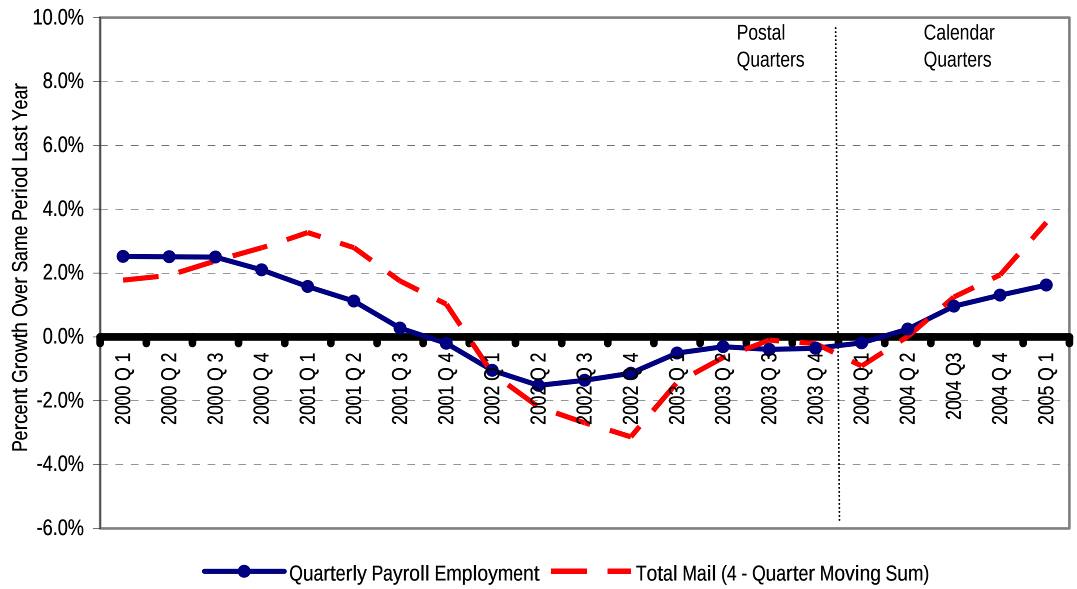
Revenue Outlook

The revenue outlook for the remainder of the year is positive in view of the strong base built in Quarter 1 and the continuing positive economic outlook. But growth is not expected to be as strong because several of the factors which we believe drove growth in Quarter 1 are unique or transitory.

Mail volume and revenue growth depends on the economy, the underlying demand for our services, and the attractiveness of competitive alternatives. Growth in economic activity, as measured by GDP and retail sales, was solid though most of 2004 and should continue into 2005. Macroeconomic forecasters Global Insight expects GDP to grow by 3.7 percent during our current fiscal year and now projects similar growth in retail sales. This is a more positive outlook for retail sales than that projected by Global Insight prior to this fiscal year when our operating plans were prepared.

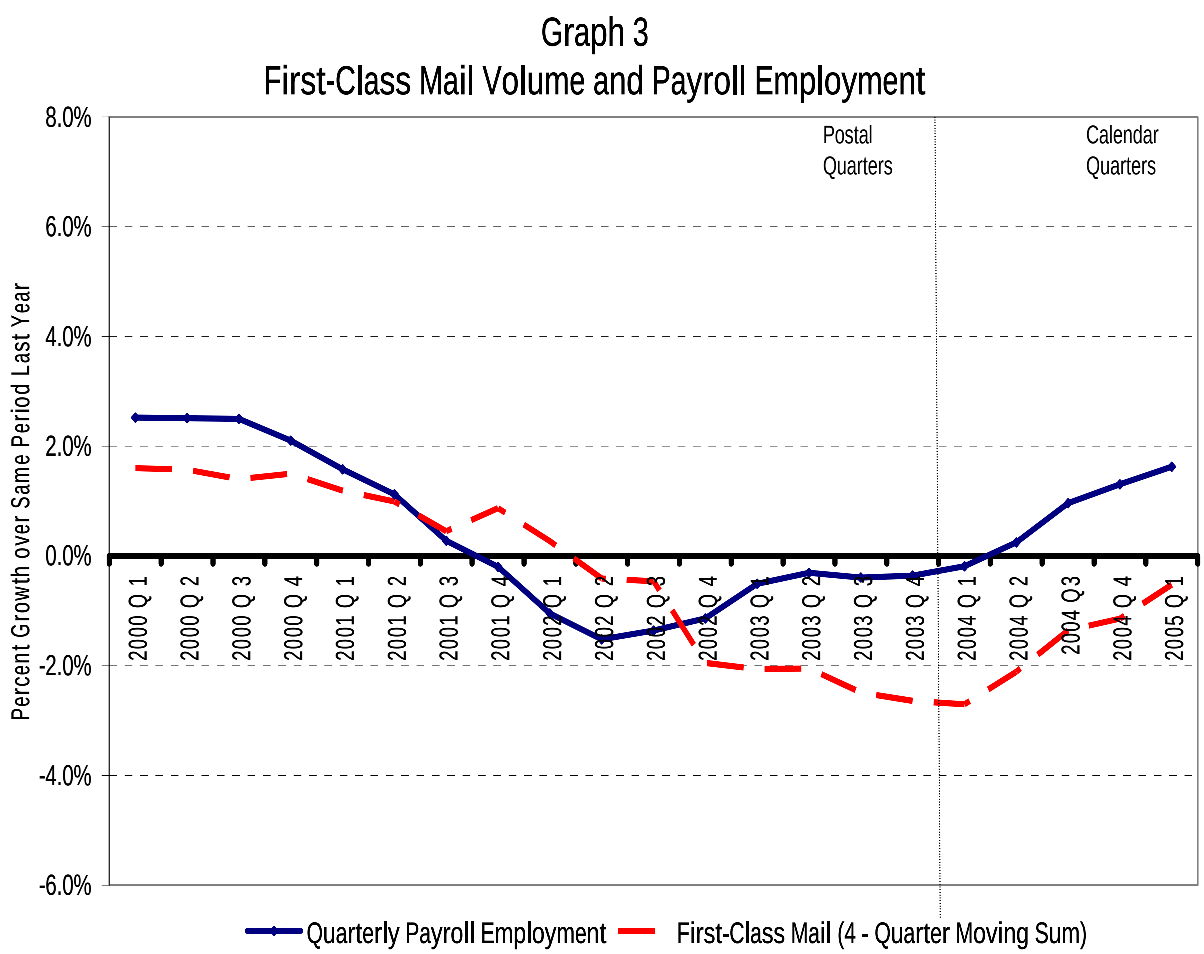
Payroll employment is a useful indicator of Total Mail volume growth as show in Graph 2 – Total Mail Volume and Payroll Employment. As Graph 2 shows, mail volume losses (measured as four-quarter moving sums) tracked declines in payroll employment in 2002 and 2003. Then mail volume growth turned positive in 2004, coincident with employment growth. This continues into 2005.

Graph 2
Total Mail Volume and Payroll Employment

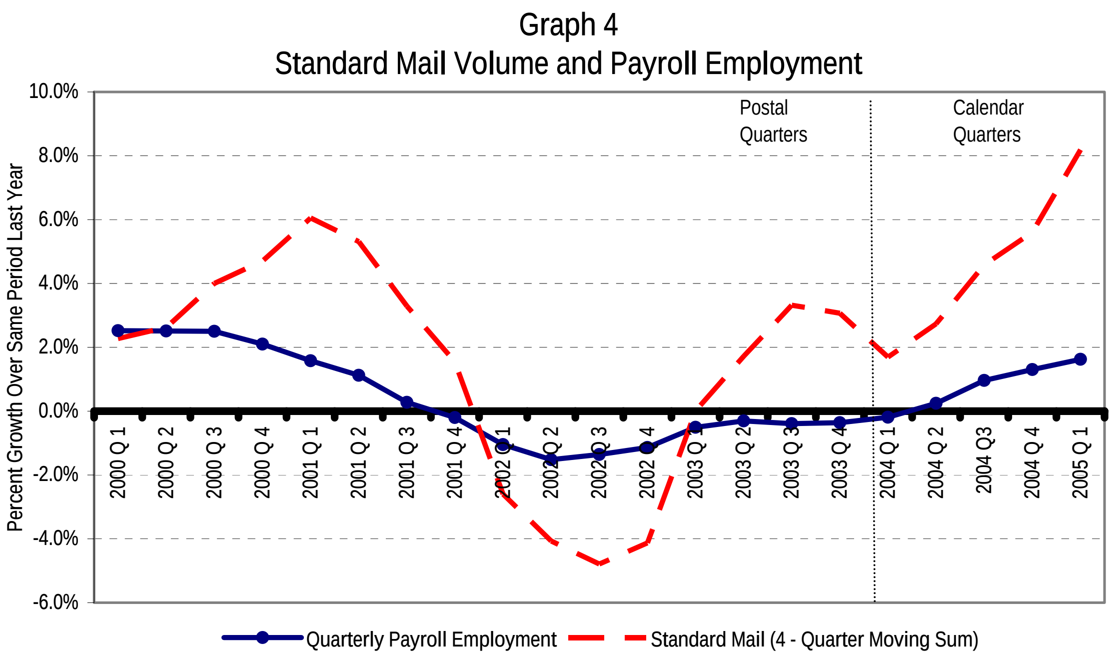


In 2004, 2.2 million payroll jobs were added to the economy. Looking forward, Global Insight expects payroll employment to grow in excess of 2 million again in 2005. Continued employment growth will positively affect Total Mail volume, but will have a lesser affect on total revenue because of mail mix changes, which are substituting low-revenue-per-piece volumes for high revenue-per-piece volumes.

First-Class Mail has been and continues to be affected by electronic diversion. Graph 3 – First-Class Mail Volume and Payroll Employment, below, tracks First-Class Mail volume growth (on a moving 4-quarter sum basis) in relation to payroll employment. This class of mail continues to struggle despite increased employment and strengthened economic growth. The Quarter 1 surges in financial services marketing and the strength of the economy has only attenuated the long-term declines in First-Class Mail volume and revenue because technological alternatives to mail are negatively impacting the demand for First-Class Mail. The Quarter 1 growth in work share First-Class Mail volume was unique in recent experience and does not appear to be sustainable.



We project continued Standard Mail volume growth through the remainder of the year due to the positive economic outlook, and continuing strength in direct marketing channels. However, growth should slow because the election impacts ran their course during Quarter 1 and there will be stronger base comparisons for the rest of the year. As Graph 4 – Standard Mail Volume and Payroll Employment shows, Standard Mail is growing more rapidly than the payroll indicator. Because Standard Mail is a favored marketing channel, volume and revenue should continue to grow more rapidly than payroll employment.



Following small increases in Priority Mail and Express Mail volume in quarter 1, we expect volumes to be relatively flat for the remainder of the year. The positive developments in Quarter 1 are expected to generate revenue that is at least $1 billion greater than we expected going into the year.

Expense Outlook

The outlook for the remaining quarters of FY 2005 is for continued modest expense growth, as witnessed in FY 2004 and Quarter 1 this year. Inflationary pressures being mitigated through program cost savings and expense controls. Our total expense plan for 2005 is $68,532 million which represents a 3.9 percent increase over FY 2004. Quarter 1 total expenses are 0.8 percent below plan. We expect continued moderate volume growth and additional possible deliveries to add approximately $500 million in additional workload related costs during FY2005. However, the outlook for achieving our targeted $1.4 billion in cost savings for the year remains good and should assist in offsetting the impact of the additional workload.

The current high level of fuel costs and the potential for further increases remains a concern. Although fuel prices have moderated recently, they remain relatively high. In addition to transportation, increased energy costs for the year will negatively affect a variety of other non-personnel items, including utility expenses, vehicle servicing costs and rural carrier equipment maintenance allowances.

In total, absent unforeseen events, we expect 2005 expenses to total slightly more than the original expense plan as we continue to efficiently handle the greater than planned workload.

Long-Term Outlook

Beyond this year the requirement to fund the escrow provisions of Public Law 108-18 will place significant demands upon our cash flow. We are required to set aside an estimated $3.1 billion in 2006 to meet this legal obligation. Accordingly, on February 16, 2005 the Board of Governors directed management to prepare a filing with the Postal Rate Commission to increase postage rates in order to raise the revenues necessary to fund the escrow. In addition, the continued electronic diversion of First-Class Mail will make it increasingly difficult to fund our ever-growing delivery infrastructure. This is discussed in detail in the 2004 Annual Report.

Pending Legislation
On January 4th, 2005, Representative John McHugh introduced H.R. 22, a bill to reform the postal laws of the United States. It has been referred to the House Government Reform Committee. The full text of the proposed legislation can be found at the website http://thomas.loc.gov/.

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 natural gas for heating facilities. We have foreign currency exchange rate risk related to the settlement of terminal dues and transit fees and other transportation and delivery arrangements with foreign postal administrations and/or their affiliates for international mail.

We did not use derivative commodity or financial instruments to manage market risk related to commodities, foreign currency exchange or interest rate fluctuations for debt instruments. Additionally, we do not purchase or hold derivative financial instruments for speculative purposes.

Item 4. Controls and procedures

We are voluntarily complying with those portions of Section 404 of the Sarbanes-Oxley Act of 2002 that relate to documentation and testing of controls over financial reporting. However, we are not working to comply as rapidly as is required for companies with publicly traded securities. We are using the Committee of Sponsoring Organizations of the Treadway Commission (COSO) control framework to document, test and report on our reporting controls. We are currently documenting and updating the controls over our financial processes. These processes are under review and existing documentation will be revised to conform to the COSO framework.

No material control deficiencies or weaknesses were identified or reported during the quarter ending December 31, 2004.

Part II. Other Information

Item 1. Legal proceedings

See Note 3, Contingent Liabilities, December 31, 2004 financial statements.

Item 5. Other information

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

Summaries of the relevant portions of our major agreements follow:

The current agreement with the American Postal Workers Union (APWU) results from the combination of an arbitration award in December 2001 and a subsequent 2-year contract extension that was ratified in December 2002. The 5-year agreement with the APWU is due to expire on November 20, 2005.
During the last year of the agreement, 2005, APWU employees will receive regularly scheduled COLA payments in March and September. In November 2004, APWU employees received a 1.3% general increase, the last scheduled general increase under the current collective bargaining agreement.

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

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

In November 2004, the National Rural Letter Carriers Association (NRLCA) extended their collective bargaining agreement with us by two years. The existing collective bargaining agreement was originally set to expire on Nov. 20, 2004. It has now been extended to Nov. 20, 2006. The agreement provides for a 1.3% wage increase effective Nov. 27, 2004, and a 1.3% increase effective Nov. 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.

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.

November Numbers Raise Service Quarter 1 Bottom-Line
February 17, 2005 - News Release #05-012

USPS Governors Elect Leaders
January 11, 2005 - News Release #05-004

U.S. Postal Service Signs National Response Plan
January 7, 2005 - News Release #05-002

Postal Service Scores Big In Customers' Delivery Comparisons
December 30, 2004 - News Release #04-100

USPS Reports Strong '04; Issues Cautionary Note
December 7, 2004 - News Release #04-088

Postal Service, Rural Carriers OK Contract Extension
November 4, 2004 - News Release #04-079

Postal Service's 2004 Performance At All Time High
November 4, 2004 - News Release #04-078

Postal Service, Discover Agreement Approved
October 28, 2004 - News Release #04-070

Item 6. Exhibits and reports
None.