

United States Postal Service

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Quarterly Financial Report

For the Three and Six Months Ended March 31, 2005

May 11, 2005

Part I. Financial Information

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Part I. Financial Information

Item 1. Financial Statements

United States Postal Service Statement of Operations (dollars in millions)

	Three months ended March 31,	
	2005 (unaudited)	2004 (unaudited)
Operating revenue	\$ 17,296	\$ 17,292
Operating expenses:		
Compensation and benefits	13,454	13,075
Transportation	1,298	1,275
Other	2,234	2,206
Total operating expenses	16,986	16,556
Income from operations	310	736
Interest and investment income	19	7
Interest expense	(54)	(2)
Net Income	\$ 275	\$ 741

See accompanying notes to financial statements.

Item 1. Financial Statements

United States Postal Service
Statement of Operations

(dollars in millions)

	Six months ended March 31,	
	2005 (unaudited)	2004 (unaudited)
Operating revenue	\$ 36,082	\$ 35,500
Operating expenses:		
Compensation and benefits	27,095	26,205
Transportation	2,717	2,453
Other	4,233	4,290
Total operating expenses	34,045	32,948
Income from operations	2,037	2,552
Interest and investment income	30	16
Interest expense	(110)	(11)
Net Income	\$ 1,957	\$ 2,557

See accompanying notes to financial statements.

United States Postal Service

Balance Sheet – Assets

(dollars in millions)

	March 31, 2005 (unaudited)	September 30, 2004
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,783	\$ 877
Receivables:		
Foreign countries	651	621
U.S. government	362	327
Other	183	187
Receivables before allowances	1,196	1,135
Less allowances	116	111
Total receivables, net	1,080	1,024
Supplies, advances and prepayments	164	220
Total current assets	3,027	2,121
Other assets, principally revenue forgone appropriations receivable	361	361
Property and equipment, at cost:		
Buildings	20,279	20,171
Equipment	17,859	17,277
Land	2,805	2,810
Leasehold Improvements	1,127	1,103
	42,070	41,361
Less allowances for depreciation and amortization	21,580	20,656
	20,490	20,705
Construction in progress	2,028	1,792
Total property and equipment, net	22,518	22,497
Total Assets	\$ 25,906	\$ 24,979

See accompanying notes to financial statements.

United States Postal Service
Balance Sheet – Liabilities & Net Capital
(dollars in millions)

	March 31, 2005 (unaudited)	September 30, 2004
Liabilities and Net Capital		
Current liabilities:		
Compensation and benefits	\$ 2,699	\$ 2,640
Estimated prepaid postage	1,261	1,256
Payables and accrued expenses:		
Commercial vendors and accrued expenses	1,252	1,739
Foreign countries	773	778
U.S. Government	66	87
Total payables and accrued expenses	<u>2,091</u>	<u>2,604</u>
Customer deposit accounts	1,695	1,606
Outstanding postal money orders	796	767
Prepaid box rent and other deferred revenue	392	397
Debt	-	1,800
Total current liabilities	<u>8,934</u>	<u>11,070</u>
Non-current liabilities:		
Workers' compensation	7,251	6,651
Employees' accumulated leave	2,074	2,006
Other	1,759	1,321
Total non-current liabilities	<u>11,084</u>	<u>9,978</u>
Total Liabilities	20,018	21,048
Net capital:		
Capital contributions of the U.S. government	3,034	3,034
Retained earnings since reorganization	2,854	897
Total Net Capital	<u>5,888</u>	<u>3,931</u>
Total Liabilities and Net Capital	<u>\$ 25,906</u>	<u>\$ 24,979</u>

See accompanying notes to financial statements.

United States Postal Service
Statement of Changes in Net Capital

Six months ended March 31, 2005 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	<u>-</u>	<u>3,065</u>	<u>3,065</u>
Balance, Sept. 30, 2004	3,034	897	3,931
Net Income—Six months ended March 31, 2005 (unaudited)	<u>-</u>	<u>1,957</u>	<u>1,957</u>
Balance, March 31, 2005 (unaudited)	<u>\$ 3,034</u>	<u>\$ 2,854</u>	<u>\$ 5,888</u>

See accompanying notes to financial statements.

United States Postal Service
Statement of Cash flows

(dollars in millions)

	Six months ended March 31, 2005 (unaudited)	Six months ended March 31, 2004 (unaudited)
Cash flows from operating activities:		
Net Income	\$ 1,957	\$ 2,557
Adjustments to reconcile net income		
To net cash provided by operating activities:		
Depreciation and amortization	1,011	1,111
Loss on disposals of property and equipment, net	7	15
Increase in USPS workers' compensation liability	600	745
Increase in employees' accumulated leave	68	30
Increase (decrease) in other liabilities	438	(52)
Changes in current assets and liabilities:		
(Increase) decrease in receivables, net	(56)	47
Decrease in supplies, advances and prepayments	56	23
Increase in compensation and benefits	59	368
Increase in estimated prepaid postage	5	-
Decrease in payables and accrued expenses	(513)	(355)
Increase (decrease) in customers deposit accounts	89	(41)
Increase in outstanding postal money orders	29	24
Decrease in prepaid box rent and other deferred revenue	(5)	(1)
Net cash provided by operating activities	<u>3,745</u>	<u>4,471</u>
Cash flows from investing activities:		
Purchase of property and equipment	(1,050)	(714)
Proceeds from sale of property and equipment	11	6
Net cash used in investing activities	<u>(1,039)</u>	<u>(708)</u>
Cash flows from financing activities:		
Issuance of debt	-	-
Payments on debt	(1,800)	(5,779)
Net cash used in financing activities	<u>(1,800)</u>	<u>(5,779)</u>
Net increase (decrease) in cash and cash equivalents	906	(2,016)
Cash and cash equivalents at beginning of year	877	2,266
Cash and cash equivalents at end of period	\$ 1,783	\$ 250
Supplemental Data		
Cash paid during the year for Interest	\$ 0	\$ 22
See accompanying notes to financial statements.		

Notes to Financial Statements

Note 1. Basis of Presentation

This interim report reflects the operations of the United States Postal Service for the three and six months ended March 31, 2005 and March 31, 2004. 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: workers' compensation liability, estimated prepaid postage, and contingent liabilities. The Civil Service Retirement System "supplemental liability" represents an additional substantial estimate that pursuant to Public Law 108-18 (P.L.108-18), 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 March 31, 2005, the results of our operations for the three and six months ended March 31, 2005, and our cash flows for the six months ended March 31, 2005.

Note 2. Retirement Programs

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

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 \$27 million dollars for the quarter and approximately \$55 million year to date.

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 by Congress of \$503 million provided additional funds for Biohazard Detection Systems, Ventilation Filtration Systems, and an irradiation facility. These funds have not yet been expended. Congress provided a similar appropriation of \$587 million in fiscal year 2002, which has been expended. For both appropriations, revenue is recognized as the capital equipment purchased with the appropriation is depreciated. For the 2nd Quarter we recorded \$13 million of depreciation expense and associated appropriations revenue. Year-to-date depreciation expense and associated appropriations revenue totaled \$15 million. This brings the total revenue recognized from the 2002 appropriation to \$302 million. Other costs of mail security and employee protection such as maintenance and consumable supplies are being funded from Postal revenue and charged as operating expense.

Note 5. Commitments

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

Capital

At March 31, 2005, our financial commitment (resources on order) for approved capital projects in process is \$2,473 million.

Rents

At March 31, 2005, our future minimum lease payments for all non-cancelable leases are as follows:

Future Minimum Lease Payments		
(\$ in millions)	March 31, 2005	
Year	Operating	Capital
2005	\$ 429	\$ 37
2006	816	74
2007	792	75
2008	751	75
2009	696	75
After 2009	6,093	566
	\$ 9,577	902
Less: Interest		226
Total Capital Lease Obligations		676
Less: Short-term Portion of Capital Lease Obligations		20
Long-term Portion of Capital Lease Obligations		\$ 656

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 \$839 million at March 31, 2005 and \$847 million at September 30, 2004. Total accumulated amortization related to capital leases was \$275 million at March 31, 2005 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. 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. 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 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, International Mail, Express Mail, Periodicals and Package Services. We serve individual and commercial customers throughout the nation. Our services compete for business in the communications, distribution and delivery, advertising and retail markets. The rates and fees for our services are subject to a regulatory review process controlled by the independent Postal Rate Commission.

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 over 143 million city, rural, post office box and highway contract delivery points. We conduct our significant operations primarily in the domestic market, with international operations representing less than 3 percent of our total revenue.

We operate and manage an integrated retail, distribution, transportation and delivery network. 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.

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 our operations as viewed through the eyes of 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 SEC 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 our organization and our 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 second quarter was \$17,296 million, compared to \$17,292 million in the corresponding quarter last year. Volume and revenue increased for all domestic mail classes, except First-Class and Periodicals. Overall for the quarter, mail volume increased by 1.2 percent or 626 million pieces.

Year-to-date operating revenue was \$36,082 million, \$582 million more than same period last year revenue of \$35,500 million. The growth was primarily due to additional pieces of Standard Mail and First-Class workshared letters. However, these gains were partially offset by a decline in First-Class single piece letters.

For the quarter, operating expenses grew by 2.6 percent. Compensation and benefits expense, driven by wage and benefit increases contributed to most of the increase over the same quarter last year. Supplies and services increased slightly due to a planned increase in advertising. Transportation expenses, driven by higher jet fuel and gasoline prices, as well as increased mail volume contributed to the remaining expense growth. However, workhour usage was 0.7 percent less than the same quarter last year which helped to offset some of the cost increases.

The combined effect of these factors is a net income of \$275 million for the three months ending March 31, which is \$466 million less than same quarter last year. Year-to-date net income of \$1,957 million is \$600 million less than the same period last year.

Summary of Interim Financial Results

Three Months Ended March 31,			Financial Results	Six Months Ended March 31,		
2005	2004	%	(\$ in millions)	2005	2004	%
\$17,296	\$17,292	0.0%	Operating revenue	\$36,082	\$35,500	1.6%
			Operating expense			
13,454	13,075	2.9%	Compensation and benefits	27,095	26,205	3.4%
1,298	1,275	1.8%	Transportation	2,717	2,453	10.8%
644	614	4.9%	Supplies and services	1,122	1,129	-0.7%
515	552	-6.6%	Depreciation and amortization *	1,018	1,126	-9.6%
1,075	1,040	3.4%	Other expenses	2,093	2,035	2.9%
16,986	16,556	2.6%	Total operating expense	34,045	32,948	3.3%
310	736	NM	Income from operations	2,037	2,552	NM
19	7	NM	Interest and investment income	30	16	NM
-54	-2	NM	Interest expense	-110	-11	NM
\$275	\$741	NM	Net Income	\$1,957	\$2,557	NM

Note: Percentages are calculated based on unrounded numbers.

NM: Not Meaningful to present as % difference.

* Depreciation and amortization is shown net of losses year-to-date on disposals of assets of \$7 million for 2005 and \$15 million for 2004.

Operating Revenue

Operating revenue for the three months ended March 31, 2005, was \$17,296 million, \$4 million or 0.02 percent higher than for the same three months in the previous year. On a year-to-date basis operating revenues were \$36,082 million, up \$582 million or 1.6 percent over the first six months of 2004.

Quarter 2 results reflected a return to the slow growth exhibited in 2004. Total mail volume in the quarter was 1.2 percent above last year's, and year-to-date volume growth was 3.4 percent. The Quarter 2 growth was primarily due to 1.3 billion additional pieces of Standard Mail and First-Class workshared letters. These and other lesser volume gains were partially offset by a decline of 653 million pieces (5.8 percent) in First-Class single piece letters, which have a higher average revenue per piece.

Single piece First-Class letter volume continued its long-term (23 consecutive quarters) decline in the second quarter, reflecting the ongoing effects of electronic diversion. For the six months ending March 31, First-Class single piece letter volume fell just shy of 1 billion pieces or 4.0 percent. Evidence from the financial services industry suggests that competition in the credit card market was heating up in Quarter 1. While this increased activity was certainly welcome news, it has not resulted in consistently strong mail volume growth from quarter to quarter as evidenced by the decline in workshare letter volume growth from 7.1 percent in the first quarter to 2.8 percent in Quarter 2.

Priority Mail and Express Mail experienced positive growth reflecting the impact of continued rate stability and economic growth. Volumes of both products are benefiting from fuel (and other) surcharges imposed by private sector competitors. But Priority Mail volume bearing a permit indicia (mailed by commercial customers) fell 2.4 percent in the second quarter after falling 11.4 percent in quarter one. These declines were more than offset by non-permit volume increases of 4.9 percent in the first two quarters. Express Mail continues to grow at steady but very low single digit percentage rates. Express Mail volumes grew 1.3 percent in the second quarter and 1.0 percent for the first half of the year.

Without the aid of the quadrennial election cycle, Standard Mail volume growth moderated to 4.1 percent in Quarter 2, down from 9.3 percent in Quarter 1. Standard Mail continues to hold its ground in the advertising market by virtue of its two dominant characteristics: targetability and measurability. Standard Mail volume has increased 6.8 percent during the first half of the year. Total Standard Mail volume did not exceed total First-Class Mail volume for the first time in three quarters. On a year-to-date basis, Standard Mail volume exceeded First-Class volume by slightly less than 200 million pieces. It is expected that in the near future Standard Mail volume in excess of First-Class Mail volume will be the rule, not the exception.

Periodical volume and revenue declined slightly (0.8 percent) in the second quarter, consistent with a long term volume trend. For the year, Periodicals Mail volume is up 0.1 percent.

Package Services volume was up in Quarter 2 on the strength of solid growth in Bound Printed Matter (up 4.0 percent) and Parcel Post (up 8.3 percent). Both products are benefiting from rate stability. Parcel Post is also benefiting from the impact of competitors' surcharges and rate increases. Growth patterns in Parcel Post mirror those in Priority Mail. Non-destination entry Parcel Post volume rose 1.4 percent in the first quarter and 2.1 percent in the second quarter. These volume increases were offset by respective declines of 2.9 and 2.5 percent in destination entry Parcel Post, used by large mail consolidators. Declines in Media Mail and Library Mail volumes brought Package Services overall growth down to 3.3 percent for the second quarter compared to the same period last year. Through the first half of the year, Packages Services volume has increased only 0.8 percent over the first half of 2004.

The "Other" volume caption includes International, Postal Penalty Mail, Free Mail for the Blind and Handicapped, and Mailgrams. Special Services are not included in "Other" volume but the related revenue is classified as "Other" revenue. A 3.6 percent decline in International Mail volume and a 6.9 percent decline in Free for the Blind resulted in a reduction in Other mail volume for the quarter. For the first half of the year, Other mail shows a 10.1 percent volume increase, attributable in large part to a spike in Postal Penalty volume of nearly 60 percent in the first quarter. Revenue growth patterns for Other mail reflect the fact Postal Penalty and Free Mail do not generate revenue for the Postal Service.

Volume by Class of Mail

Three Months Ended March 31,			Volume	Six Months Ended March 31,		
2005	2004	% change	(millions of pieces)	2005	2004	% change
24,656.6	24,971.7	-1.3	First-Class Mail	51,084.8	50,859.4	0.4
218.8	213.0	2.7	Priority Mail	458.4	447.0	2.6
13.8	13.6	1.3	Express Mail	27.3	27.0	1.0
2,290.5	2,309.3	-0.8	Periodical Mail	4,630.7	4,625.5	0.1
24,327.5	23,375.0	4.1	Standard Mail	51,281.8	48,038.7	6.8
288.3	279.0	3.3	Package Services	602.9	598.1	0.8
347.2	355.1	-2.1	Other	815.7	740.9	10.1
52,142.7	51,516.7	1.2	Total Mail Volume	108,901.6	105,336.6	3.4

Note: Percentages are calculated based on unrounded numbers.

Given constant postage rates over the last few years, changes in revenue performance are expected to be highly correlated with changes in mail volume. Differences in revenue and volume growth rates are attributable to mail mix changes within the categories reported herein. Specifically, if volume growth in a particular mail class exceeds revenue growth, this indicates low yield (in terms of revenue per piece) volume within the class was growing faster than high yield volume.

Revenue by Class of Mail

Three Months Ended March 31,			Revenue	Six Months Ended March 31,		
2005	2004	% change	(\$ millions)	2005	2004	% change
9,059	9,282	-2.4	First-Class Mail	18,808	18,944	-0.7
1,130	1,094	3.3	Priority Mail	2,423	2,367	2.4
215	213	1.2	Express Mail	433	430	0.8
541	545	-0.8	Periodical Mail	1,104	1,107	-0.3
4,598	4,452	3.3	Standard Mail	9,652	9,138	5.6
551	549	0.4	Package Services	1,197	1,208	-0.9
1,202	1,157	3.9	Other	2,465	2,306	6.9
17,296	17,292	0.0	Total Operating Revenue	36,082	35,500	1.6

Note: Percentages are calculated based on unrounded numbers.

Since high yield single piece First-Class Mail volume fell while relatively low yield workshare volume rose, First-Class Mail revenue had a lower growth rate than First Class volume. Similarly, within Standard Mail growth is positive for lower yield categories such as ECR, Regular Automated, and Nonprofit, and negative for non-automated presort mail. This depresses the revenue growth relative to the volume growth.

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

Compensation and Benefits and Workhour Analysis

Total compensation and benefits for Quarter 2 were \$13,454 million, or 2.9 percent higher than the prior year period amount of \$13,075 million. This increase of \$379 million was driven by salary and benefit increases of \$482 million offset by a 0.7 percent reduction in workhours, the equivalent of \$83 million. Driving the increase in salary and benefits was an increase in wages of \$381 million, retirement contributions of \$56 million, \$45 million in employee health benefits, \$51 million in retiree health benefits and \$25 million in other personnel costs. These increases were offset by a reduction of \$96 million in workers compensation costs. Year-to-date total compensation and benefits costs are \$27,095 million, 3.4 percent or \$890 million higher than same period last year. The \$890 million increase was driven by salary and benefits increases of \$925 million. Of this amount, \$706 million were for wages, retirement contributions of \$117 million and \$98 million for employee health benefits. A slight increase in workhour usage added the equivalent of \$4 million. Retiree health benefit increases of \$74 million and other personnel cost increases of \$35 million were offset by a \$144 million decrease in workers compensation costs.

Wages

Wages grew in Quarter 2 by \$381 million and YTD have increased \$706 million as compared to same period last year. This is due to increases in both wage rates and an increase in overtime usage. Eligible bargaining unit employees received raises of 1.3 percent in November 2004, along with annualized cost of living increases of \$624 in September, 2004 and \$208 in March, 2005 (eligible National Association of Letter Carrier employees received an annualized cost of living increase of \$229 in March, 2005). Included in the wages growth is the impact of 25.0 percent growth in overtime hours in Quarter 2 and 18.8 percent year-to-date. This contributed \$263 million in Quarter 2 and \$456 million year-to-date to the total wage increases. Increases in overtime were warranted due to the increase in volume and workload. Hiring of career employees was kept to a minimum as our forecast calls for the volume and related workload to level off. At the end of Quarter 2, career complement was 10,762 below last year.

Our cost of providing health benefits to current employees increased by \$45 million, or 3.7 percent, from the same quarter last year. Health benefit costs per employee rose by an average of 5 percent. Year-to-date, our cost of providing employee health benefits have increased by \$98 million or 4.1 percent.

Other Personnel Compensation

Workers' Compensation costs represented approximately 2.1 percent of compensation and benefits expenses in Quarter 2 and 2.2 percent year-to-date. Our employees are covered by the Federal Employees' Compensation Act, administered by the Department of Labor's Office of Workers' Compensation Programs (OWCP). The current year workers' compensation liability and expense accruals are estimated using an actuarial model based on the number of cases, severity of the injury, the age of the injured employee, the trend of our experience with such an injury and other factors. The primary drivers for our Workers' Compensation expense are the number of claims reported and cost per claim. Data from OWCP show that for the first 9 months of the current chargeback year (July 1, 2004 through March 31, 2005), paid Medical claims are down 1.8 percent, while the average cost for these claims rose 8.9 percent. For compensation claims, the number of paid claims is down 1.6 percent with the average cost per claim increasing by only 0.7 percent. Total cash outlays by the OWCP for these claims have declined for the six months ending March 31, 2005, as compared to the prior year. Our expenses are subject to adjustment based on claims information provided by OWCP. In the second quarter we had \$276 million in workers' compensation expense, which is \$96 million less than last year's second quarter expense. Year-to-date we had \$600 million in workers' compensation expense, which is \$144 million less than last year's expense.

Retiree Health Benefits costs were about 2.8 percent of compensation and benefits expense in Quarter 2. 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 March 31, 2005, we had approximately 441,000 participants on the rolls, an increase of about 7,900 over the prior year. Our expense related to retiree health benefits was \$381 million during this quarter, compared to \$330 million in the second quarter of 2004. Year-to-date expense was \$735 million compared to \$661 million in 2004.

Workhours and salaries and benefits by Function for Quarter 2 of 2005 compared with the same period last year. Functional definitions can be found in Item 6.

Workhours Three Months Ended March 31, (Thousands)				Compensation and benefits Three Months Ended March 31, (\$ Millions)		
2005	2004	%		2005	2004	%
			Salaries & Benefits by Function			
			Operations:			
2,409	2,291	5.1%	-Operations Support	\$ 106	\$ 97	9.5%
83,275	84,383	-1.3%	-Mail Processing	2,869	2,829	1.4%
42,834	42,321	1.2%	-Rural Delivery	1,238	1,168	6.1%
116,174	115,734	0.4%	-City Delivery	4,150	4,008	3.6%
7,916	8,025	-1.4%	-Vehicles Services	297	290	2.4%
20,235	20,520	-1.4%	-Plant & Equip Maintenance	751	731	2.7%
57,972	58,544	-1.0%	-Customer Services, Retail & Sales	1,999	1,954	2.3%
30,198	31,632	-4.5%	Postmasters & Installation Heads, Administration, and Other	1,299	1,233	5.3%
361,013	363,450	-0.7%	Total Salaries & Benefits	12,709	12,310	3.2%
			Other Personnel Compensation			
			Workers' Compensation	276	372	-25.7%
			Retiree Health Benefits	381	330	15.3%
			Other	88	63	40.1%
361,013	363,450	-0.7%	Total	\$13,454	\$13,075	2.9%

Note: Percentages are calculated based on unrounded numbers.

Quarter 2 Workhours

A change in workhours is usually created by a change in workload, a change in productivity, or both. The two major workload factors that impact our operations are changes in mail volume and changes in possible deliveries. In our second quarter, mail volume increased by 626 million pieces, or 1.2 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, require the equivalent of 0.4 million additional workhours. Continued cost control actually resulted in a decrease of 2.4 million workhours, or 0.7 percent, from the comparable period last year. This is equivalent to \$83 million.

Workhours in the mail processing function decreased by 1.1 million workhours through implementation of initiatives to increase productivity using cost savings programs and improvements in operational efficiencies. Our 2005 Integrated Financial Plan provides an outline of these programs and operational efficiency efforts. Total deliveries continue to grow at a constant rate of about 1.8 million deliveries per year, resulting in a combined rural delivery and city delivery increase of 1.0 million workhours over the same quarter last year. The workload impact of this increase in the delivery network is equivalent to 1.2 million

workhours. Route inspections, which began in Quarter 2, will provide a basis for capturing some savings in the future as city delivery routes are realigned or eliminated.

Workhours in administrative functions were 1.4 million less than the same quarter last year. This is due to a continued effort to reduce administrative costs.

Workhours and salaries and benefits by Function for Quarter 2 year-to-date 2005 compared with the same period last year. Functional definitions can be found in Item 6.

Workhours Six Months Ended March 31, (Thousands)				Compensation and benefits Six Months Ended March 31, (\$ Millions)		
2005	2004	%		2005	2004	%
			Salaries & Benefits by Function			
			Operations			
4,648	4,506	3.1%	-Operations Support	\$ 204	\$ 189	8.1%
173,551	175,122	-0.9%	-Mail Processing	5,865	5,747	2.1%
87,561	84,625	3.5%	-Rural Delivery	2,495	2,326	7.3%
236,069	233,291	1.2%	-City Delivery	8,381	7,984	5.0%
16,050	16,171	-0.7%	-Vehicles Services	599	578	3.6%
40,542	41,090	-1.3%	-Plant & Equip Maintenance	1,502	1,451	3.5%
118,492	118,180	0.3%	-Customer Services, Retail & Sales	4,059	3,915	3.7%
59,927	63,735	-6.0%	Postmasters & Installation Heads, Administration, and Other	2,506	2,496	0.4%
736,840	736,720	0.0%	Total Salaries & Benefits	25,611	24,686	3.7%
			Other Personnel Compensation			
			Workers' Compensation	600	744	-19.4%
			Retiree Health Benefits	735	661	11.1%
			Other Personnel Compensation	149	114	30.8%
736,840	736,720	0.0%	Total	\$27,095	\$26,205	3.4%

Note: Percentages are calculated based on unrounded numbers.

Year-to-Date Workhours

Year-to-date, mail volume increased by 3.565 billion pieces, or 3.4 percent, as compared to the same period last year. This workload increase would, without productivity improvement, require the equivalent of 6.2 million additional workhours. Continued cost control kept workhour usage even with the comparable period last year.

Year-to-date workhours in the mail processing function decreased by 1.6 million workhours due to cost savings programs and improvements in operational efficiencies. As stated previously, total deliveries

continue to grow at a constant rate of about 1.8 million deliveries per year, resulting in a workload impact in the delivery network of 2.4 million hours over the first six months of last year.

Again, due to a continued effort to reduce costs, workhours in administrative functions are 3.8 million less than the same period last year.

Employee Complement

Employee complement decreased in Quarter 2. The number of career employees, not including the Office of the Inspector General (OIG), was reduced 4,188 during the quarter through attrition. The pace of complement reductions picked up during the quarter, compared to recent quarters. This is consistent with the Quarter 1 forecast that complement reductions would increase during the second quarter. The number of career employees was reduced 5,528 since the end of last year. In spite of the increased pace of attrition during Quarter 2, we expect the annual complement reduction for 2005 will likely be less than recent years. At the end of Quarter 2 career complement, not including the Office of Inspector General, is 701,175.

Retirement Expense

With certain exceptions, our employees participate in one of three retirement programs based on their date of employment. These programs are the Civil Service Retirement System (CSRS), the Dual CSRS/Social Security System, and the Federal Employees Retirement System (FERS). Each of these programs is described in further detail in note 6 to the financial statements included in our 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 our 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 \$27 million dollars for Quarter 2 and \$55 million year-to-date.

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 10.1 percent of our total expenses during the second quarter. They increased by \$233 million (inclusive of the FERS contribution rate change of \$27 million) compared to Quarter 2 of 2004, when these benefits represented 9.0 percent of total expenses. Year-to-date retirement expenses, representing 10.1 percent of our total expenses increased by \$279 million (inclusive of the FERS contribution rate change of \$55 million) compared to 2004, when these benefits represented 10.5 percent of total expenses.

Transportation

Transportation expense of \$1,298 million is \$23 million, or 1.8 percent, over last year's second quarter expense of \$1,275 million. Air transportation of \$578 million was \$22 million or 4.0 percent over same period last year and highway transportation of \$649 million was \$26 million or 4.2 percent over same period last year. These increases were partially mitigated by decreased charges for Rail transportation of \$13 million dollars due to discontinued use of Amtrak mail delivery service and a decline in other transportation categories of \$12 million dollars.

While overall volume was up, higher fuel prices contributed to the increase in our transportation expense. This rise in fuel prices is not offset by fuel surcharges to our customers. During the second quarter, the index by which the jet fuel costs for our dedicated air carrier are calculated increased 44.3 percent from the same quarter last year. This resulted in an increase in fuel costs for the dedicated air transportation alone

of approximately \$18 million. During the same time frame, weekly retail gasoline prices increased an average of \$0.288 per gallon from a year ago

Highway transportation was impacted by increased fuel charges. During Quarter 2, weekly highway diesel prices increased an average of \$0.468 per gallon from a year ago. Increased mail volume also impacted this category as well.

Year-to-date total transportation expense at \$2,717 million is \$264 million over last year. This increase is broken down into two major categories; \$105 million for Highway Transportation and \$165 million for Air Transportation. Rail transportation and other transportation expenses declined by a combined \$6 million.

The majority of our highway expense growth occurred in the first quarter. This first quarter increased mail volume was driven by a strengthening economy, a surge in credit card solicitations and election year mailings. Along with volume, higher fuel prices are the drivers for these increases. Fuel costs for our dedicated air transportation network increased \$49 million year to date over the same period last year. Additionally, international mail transportation which includes costs to deliver mail originating in the United States and destinating in another country (known as terminal dues), increased \$69 million year to date over the same period last year. All of the international transportation increase occurred in the first quarter. Year to year fluctuations in terminal dues expenses are normal and are due to timing and amounts of settlements with foreign postal administrations

Supplies and Services

Supplies and services expenses of \$644 million were \$30 million or 4.9 percent higher than last year's comparable quarter. Planned increased advertising expenses accounted for \$20 million of this increase. Year-to-date expenses were \$1,122 million which is \$7 million or 0.7 percent less than same period last year. Increased advertising spending of \$38 million was offset by a reduction in service contracts of \$42 million as a result of timing factors and supply chain management initiatives to control spending.

Depreciation and Amortization

Depreciation expenses of \$515 million were \$27 million or 6.6 percent less than last year's comparable quarter. Year-to-date depreciation expenses are \$1,018 million which is \$108 million or 9.6 percent less than same period last year. Depreciation declines in Quarter 2 and year-to-date as the result of consistent decreases in capital spending in prior years. Year-to-date depreciation expenses include losses of \$7 million on disposals of assets with a cost of \$97 million for 2005 and losses of \$15 million on disposals of assets with a cost of \$93 for 2004.

Other Expenses

Other expenses of \$1,075 million were \$35 million or 3.3 percent higher than last year's comparable quarter. The major components included in this category are rent and utilities of \$431 million, vehicle maintenance services of \$243 million, information technology of \$78 million and communications of \$58 million. Rent and utilities, up 4.6 percent, have experienced steady reasonable growth in Quarter 2. Vehicle maintenance services are increasing, up 9.5 percent, as the fleet ages and by the increasing cost of fuel in Quarter 2. Reduction in information technology costs of \$29 million or 27.1% were a reflection of the continuing downward price trend in this industry and favorable negotiation on software maintenance and licensing agreements. Communications charges have increased primarily due to upgrades in telephone and networking services.

Year-to-date, we witnessed the same trend as other expenses of \$2,093 million increased \$60 million or 2.9 percent. Rent and utilities of \$814 million up 4.4 percent, vehicle maintenance services of \$480 million up 8.8 percent, information technology of \$148 million down 32.1 percent and communications of \$109 million up 3.8 percent.

Interest Expense

Interest expense, excluding deferred retirement interest, decreased by \$2 million compared to the same quarter last year which reflects our payoff of debt. Interest expense on CSRS supplemental retirement obligation was \$55 million for Quarter 2, 2005 and \$109 million year-to-date based on 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 2 TFP related workload increased by 1.0 percent, while resource usage decreased 0.5 percent, yielding a 1.5 percent increase in TFP. TFP growth has been positive in twenty-two of the last twenty-three quarters. Approximately half of the Quarter 2 workload increase of 1.0 percent was driven by increases in miscellaneous outputs, primarily the transportation of military mail. The expanding delivery network, as described previously, contributed 0.4 percent to the increase in workload while mail volume contributed less than 0.1 percent during Quarter 2. Resource usage decreased this quarter and was driven by decreases in labor usage and capital. These decreases were offset somewhat by an increase in material usage that was driven by increases mainly in air transportation.

The year-to-date TFP related workload increased by 2.2 percent, while resource usage remained the same, yielding a 2.2 percent increase in TFP. This productivity growth is equivalent to approximately \$783 million in expense reductions year-to-date.

Financial Condition

Debt and Liquidity

As of March 31, 2005, we had no outstanding debt with the U. S. Treasury's Federal Financing Bank. This represents a reduction of \$1,800 million from year-end 2004, and is \$1,494 million less than the same period last year. Cash and cash equivalents were \$1,783 million, \$906 million higher than September 30, 2004, and \$1,533 million higher than at the end of March, 2004.

The first two quarters of our year typically produce strong cash flow. We used the net cash flow from our operating activities to eliminate our outstanding debt after providing for capital investment.

We do not anticipate any borrowing until the end of the year. In September, we will have approximately \$1,200 million in annual payments for workers' compensation and retirement liabilities. We continue to maintain two credit lines with the Federal Financing Bank. One credit line enables us to draw upon up to \$3,400 million with two day's notice; the other up to \$600 million on the same business day that funds are requested. In addition, we can also use a series of other notes with varying provisions to draw upon with two day's notice.

Capital Expenditures and Commitments

The capital commitments year-to-date through the second quarter were \$757 million compared to \$821 million in 2004.

During the second quarter, the Board of Governors approved funding for two projects: construction of the Southern Maine Processing and Distribution Center and the Atlantic City, New Jersey Main Post Office. Additional commitments were made to the following Board approved projects:

- Integrated Dispatch and Receipt System - automates mail dispatch and receipt functions by deploying a site-specific combination of ten equipment systems at each facility.
- Emergency Preparedness Protection - permits completion of the purchase and installation of 1,705 Bio-hazard Detection System units in 282 mail processing facilities and support sites nationwide.

The capital cash outlays year-to-date were \$1,050 million in 2005 compared with \$714 million in 2004. Capital Commitments, Expenditures, and Resources on Order, below, summarizes 2005 activity year-to-date compared to same period last year.

Capital Commitments, Expenditures, and Resources on Order

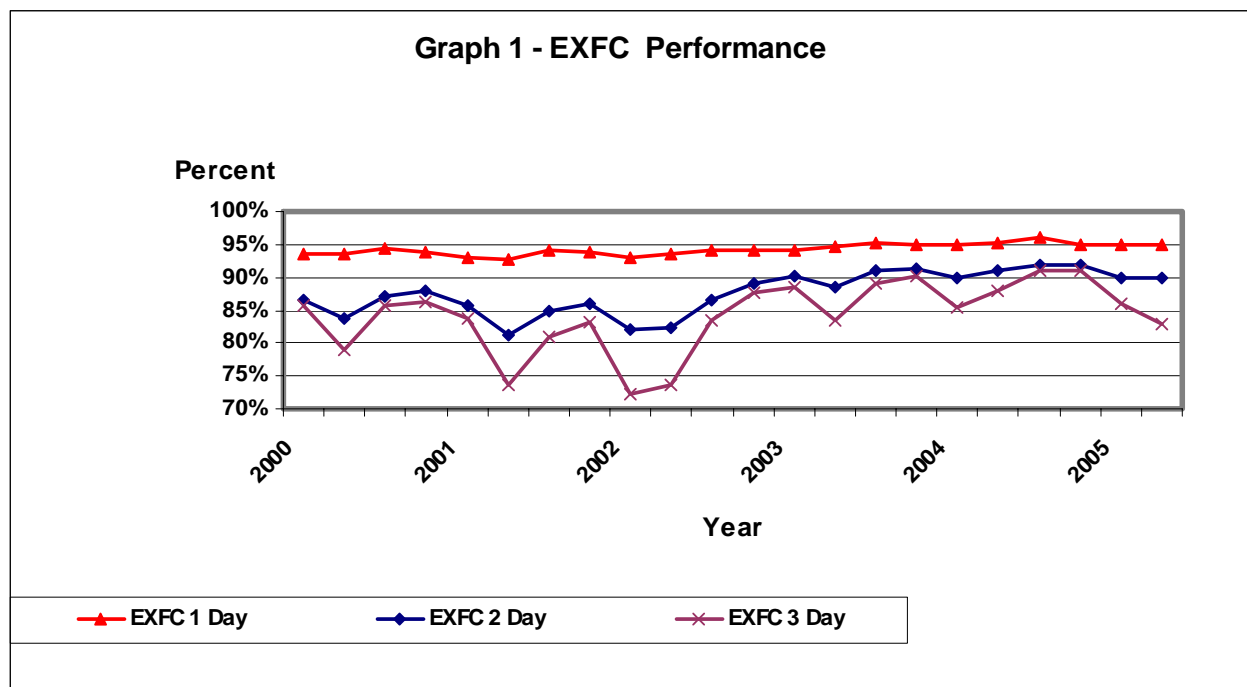
CAPITAL INVESTMENTS (\$ millions)	COMMITMENTS		CASH OUTLAYS		RESOURCES ON ORDER	
	Year to Date Through March 31,		Year to Date Through March 31,		March 31,	September 30,
	2005	2004	2005	2004	2005	2004
CONSTRUCTION AND BUILDING PURCHASE	\$ 99	\$ 39	\$ 109	\$ 65	\$ 179	\$ 192
BUILDING IMPROVEMENTS	74	91	195	113	256	380
MAIL PROCESSING EQUIPMENT	166	448	354	290	1,398	1,601
VEHICLES	20	162	107	67	32	126
RETAIL EQUIPMENT	3	26	50	39	48	95
POSTAL SUPPORT EQUIPMENT	395	55	235	140	560	414
TOTAL	\$ 757	\$ 821	\$ 1,050	\$ 714	\$ 2,473	\$ 2,808

Service and Performance

Management monitors several key statistics to determine performance against service standards and monitor 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, we have maintained a high level of service for all categories. This quarter is the fifth consecutive quarter for which we have achieved national EXFC 1 Day scores of 95 percent or above. EXFC 2 day results remained flat from the prior quarter while showing a modest decline from the same quarter last year. EXFC 3 day results have declined for the prior two quarters and for the

same quarter last year. This decline is associated with seasonal factors, such as localized severe weather which impacts 3 day delivery of mail since it is carried entirely by air. Performance issues at the airlines also affected the 3 day results.

Customer Satisfaction

Independently measured customer satisfaction for residential household customers for Quarter 2 showed that 93 percent of these customers rated their experience with us as “excellent”, “very good” or “good.” We can now claim 14 continuous quarters at 93 percent or higher.

Rate and Classification Activity

The Postal Rate Commission (PRC) is an independent establishment of the executive branch of the United States government. The Commission reviews our proposals to establish and change domestic mail rates, fees and mail classifications. Upon request by us, the Commission holds public hearings and issues recommended decisions to our Governors, 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 our 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 our 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.

We filed a rate case with the PRC April 8, 2005 seeking an expedited recommended decision to raise rates and fees 5.4 percent for almost all categories. The filing is unique in that the decision to seek a rate increase is due solely to the requirement of P.L.108–18 that we establish a \$3.1 billion escrow fund. The law does not stipulate how the funds are to be used. Our rate case calls for an almost uniform 5.4 percent rate and fee increase spread over all classes and subclasses of mail and special services. The postage for a one-ounce piece of First-Class Mail would go from 37 to 39 cents in early 2006. Should legislation be enacted that eliminates the escrow funding requirement, this rate case will be withdrawn. The last postal rate increase was three cents on June 30, 2002. Information on the filing can be found at www.usps.com/ratecase.

The PRC issued no recommended decisions during the Quarter.

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 we 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. On April 15, 2005, the Commission recommended rates and classifications for Premium Forwarding Service. The Board of Governors will review and determine whether to accept and implement the PRC recommendation.

One request for classifications, rates and fees to implement a negotiated service agreement (NSA) functionally equivalent to the Capital One NSA, (PRC Docket No. MC2002-2) is pending before the Commission. This is with HSBC North American Holdings, Inc. (PRC Docket No. MC2005-2). This agreement pertains to First-Class Mail and First-Class Mail solicitations for credit that bear the endorsement specified by us. This agreement creates opportunities to reduce costs and increase revenues by tailoring our mail services to the unique characteristics of our mailers.

On February 16, 2005, the Governors acted on the PRC’s Recommended Decision on the Bank One Corporation NSA (PRC Docket No. MC2004-3). The Governors allowed the recommendations to take effect under protest, and returned the case to the PRC to allow reconsideration of whether a cap should limit the discounts available to Bank One under the NSA. The Governors also asked the PRC to clarify its views on what circumstances and evidence would justify not applying a cap to similar NSAs in the future.

There are five proposed rulemaking hearings in process. The first concerns defining the term “postal service”; the second involves new procedural rules concerning the information related to non-postal products that will be required to be submitted as a part of a rate filing; the third involves an expansion of the PRC’s administrative procedures to require additional, detailed periodic reporting; the fourth is a solicitation

of comments on the first use of the rules for functionally equivalent NSAs; and the fifth proposes rules applicable to requests to renew or modify previously recommended NSAs. Seven complaint cases are also open concerning removal of collection boxes, the Electronic Postmark, cost-based rates for Periodicals Mail, alleged First-Class Mail service level changes, sale of stamped stationary, alleged Express Mail service level changes, and the closure of a postal service facility. 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 2005 is positive. As we noted in the Quarter 1 Financial Report, 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 through the first six months of the year was substantially better than we had planned entering the year. For the year, we planned for a \$200 million net loss. The positive results achieved thus far and our projections for the remainder of the year indicate that we will achieve a net income in excess of \$1 billion, however, this net income will be considerably less than the \$3.1 billion achieved in 2004.

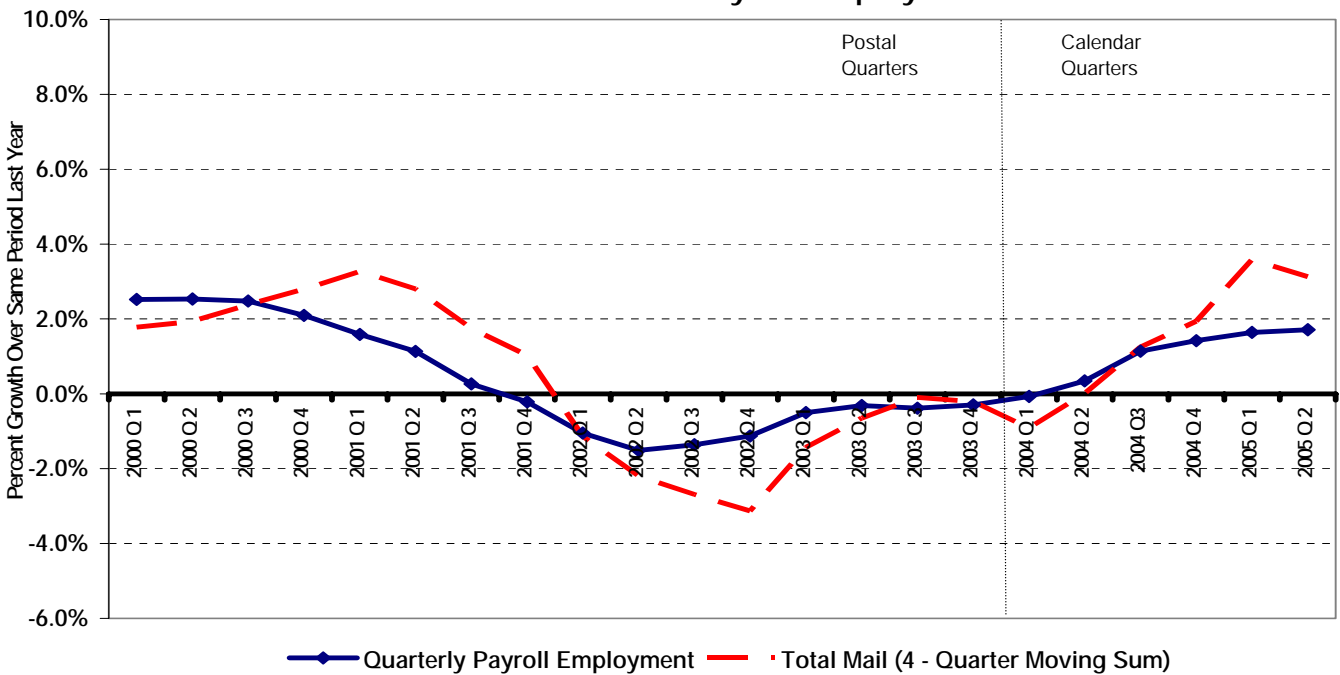
Revenue Outlook

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 through the remainder of the year because several of the factors which we believe drove growth in Quarter 1 are unique or transitory. Generally, Quarter 2 results bear this assessment out.

Mail volume and revenue growth depend 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 through most of 2004 and should continue into 2005. Macroeconomic forecasters Global Insight expects GDP to grow by 3.8 percent during our current year, a slight increase (of 0.1 percentage points) over their estimate in January. Retail sales, an important driver of mail volume, are expected to grow at a healthy 4.8 percent for the remainder of 2005. This is a more positive outlook for retail sales than that projected by Global Insight prior to this year when our operating plans were prepared.

Payroll employment is a useful indicator of Total Mail volume growth as shown 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. In fact, mail volume growth has exceeded employment growth for three consecutive quarters.

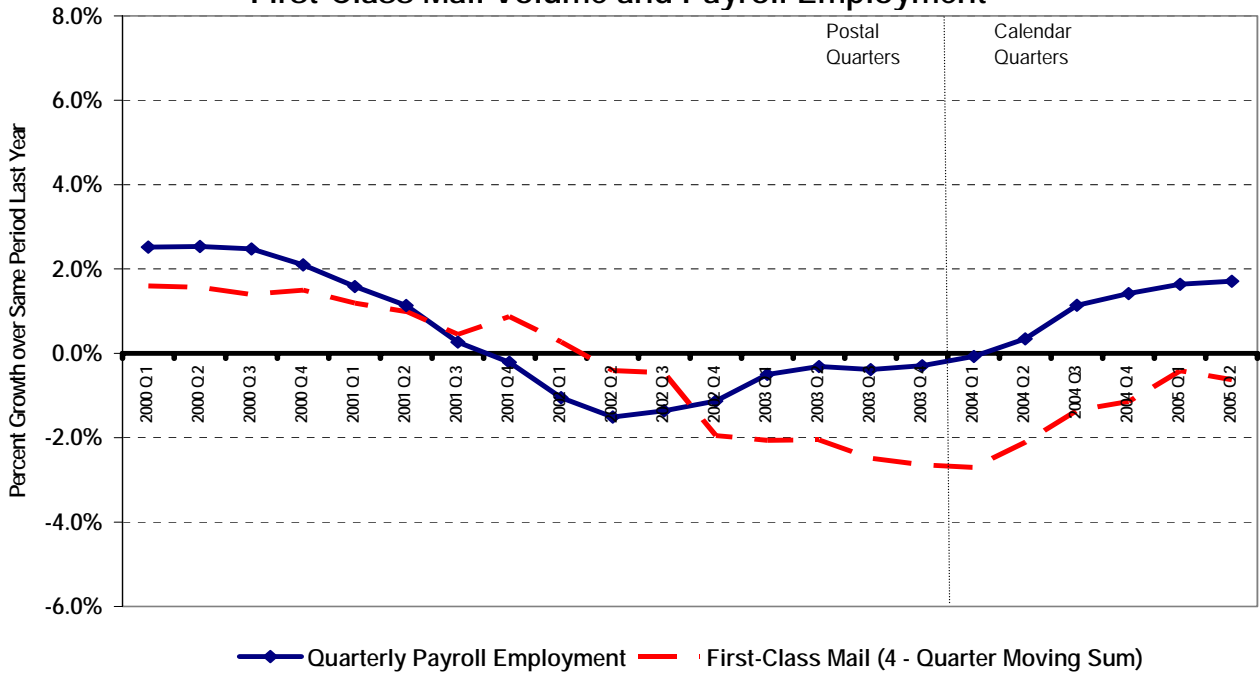
Graph 2
Total Mail Volume and Payroll Employment



For the remainder of the year, Global Insight expects payroll employment to grow at a 1.8 percent rate, adding approximately 2 million jobs in 2005. Beyond 2005, Global Insight has begun to dial back its employment forecast by 0.2 to 0.3 percentage points per year for 2006-2007. 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.

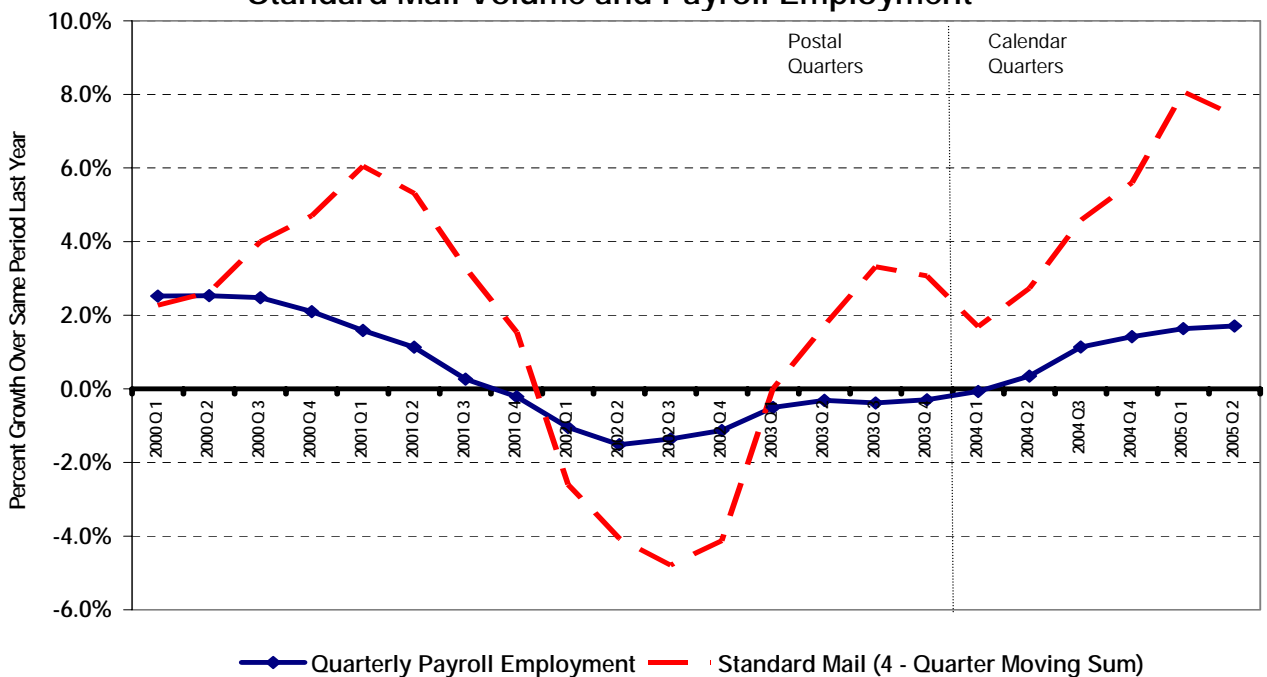
First-Class Mail has been and continues to be affected by electronic diversion. Graph 3 – First-Class Mail Volume and Payroll Employment tracks First-Class Mail volume growth (on a moving 4-quarter sum basis) in relation to payroll employment. This class of mail continues to struggle despite increased employment and strengthened economic growth. The Quarter 1 surge in financial services marketing and the strength of the economy 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 2 growth in workshare First-Class Mail volume was much more typical of recent history. Single piece volume losses more than doubled in Quarter 2, and workshare volume gains were one-half as great as in the first quarter.

Graph 3
First-Class Mail Volume and Payroll Employment



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.

Graph 4
Standard Mail Volume and Payroll Employment



There have been small increases in Priority Mail and Express Mail volume in the first half of the year. We now expect that the modest growth seen in the first half of the year will continue in the second half, even though the marketplace for Priority Mail, Express Mail, and Parcel Post has never been more competitive.

Global Insight's April forecast update raises some concerns about key economic variables that bear continued observation. As stated in their report: "Mixed signals on growth, rising oil prices, and a more hawkish Federal Reserve have made the outlooks for both the economy and the Fed policy more uncertain." In March, Global Insight was predicting a roll back in oil prices from \$50 per barrel to about \$35 per barrel over the course of the next several months. In April, that roll back was to \$46 per barrel. Although oil prices are not a direct determinant of mail volume, experience has shown that elevated oil prices do have the potential for adverse effects on consumer and business buying decisions.

Expense Outlook

The outlook for the remaining quarters of 2005 is for continued modest expense growth, as witnessed in 2004 and Quarter 1 this year. Inflationary pressures will continue to be 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 2004. Through Quarter 2 total expenses are 3.6 percent above same period last year. We expect continued moderate volume growth and additional deliveries points to add approximately \$500 million in additional workload-related costs during 2005. The majority of this workload should be absorbed and the outlook for achieving our targeted program cost savings for the year remains good.

The current high level of fuel costs and the potential for further increases remain a concern. 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, rents and leases and rural carrier equipment maintenance allowances.

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

Pending Legislation

On January 4th, 2005, Representative John McHugh introduced the Postal Accountability and Enhancement Act, 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/>.

On March 17th, 2005, Senator Susan Collins introduced the Postal Accountability and Enhancement Act, S.662, a bill to reform the postal laws of the United States. It has been referred to the Senate Homeland Security and Governmental Affairs Committee. The full text of the proposed legislation can be found at the website <http://thomas.loc.gov/>.

Our Postmaster General/CEO, John E. Potter testified before Congress on April 26, 2005 concerning the legislation identified above and that testimony can be found at the usps.com website as listed under the press releases in Item 5.

The Board of Governors, in a letter dated February 24, 2005 responded as well to proposed legislation with recommendations.

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 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 in the process of 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 March 31, 2005.

Part II. Other Information

Item 1. Legal proceedings

See Note 6, Contingent Liabilities, March 31, 2005 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 March 2001 and a subsequent 2-year contract extension that was ratified in March 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 November 20, 2004. It has now been extended to November 20, 2006. The agreement provides for a 1.3% wage increase effective November 27, 2004, and a 1.3% increase effective November 26, 2005. Terms of the agreement include continuing the March and September COLA payments, establishing a standard time allowance for reloading and unloading vehicles, increasing the reimbursement rate for rural carriers who furnish their own vehicles and creating a joint task force to discuss issues related to future developments in mail delivery. All other provisions of the contract remain in effect.

Other Financial Information

Other financial information 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>.

Postal Service Invites Customer Comment About Future Direction

May 3, 2005 - News Release #05-037

Statement of John E. Potter, Postmaster General/CEO Before House Subcommittee

April 26, 2005 - For Immediate Release

U.S. Postal Service Seeks Customized Postage Vendors

April 26, 2005 - News Release #05-034

Congressional Testimony of John E. Potter, Postmaster General/CEO

April 14, 2005 - For Immediate Release

Postal Service's COO Patrick Donahoe Becomes Deputy Postmaster General

April 12, 2005 - News Release #05-032

Escrow Rate Case Filed

April 8, 2005 - News Release #05-030

Statement Of Azeezaly S. Jaffer, VP Public Affairs And Communications

March 31, 2005 - For Immediate Release

Deputy PMG Nolan To Retire In May

March 8, 2005 - News Release #05-016

USPS Seeks To Extend Negotiated Pricing To Fourth Mailer

February 25, 2005 - News Release #05-014

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

Item 6. Exhibits and reports

Functional Definitions

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.

Mail Processing includes workhours for manual, mechanized and automated distribution of the mail

Rural and City Delivery functions include delivery and collection of mail, carrier office and street activities, supervisory support, and training.

Vehicle Services includes hours for operating and maintaining the postal vehicle fleet and support hours for stockroom duties and vehicle accident investigations.

Plant and Equipment Maintenance includes hours for maintaining mail handling equipment, building maintenance and custodial activities.

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.

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.

2004 Cost Revenue Analysis Report

Annually, we prepare a detailed analysis of product cost. The analysis is summarized in the Cost Revenue Analysis Report (CRA) and is subjected to an extensive review by our independent auditors. The report for 2004 was completed and issued in April 2005. This report serves as an integral part of our rate making process. The full report is available at <http://www.usps.com/financials/cra/welcome.htm>.

In 2004, the average unit cost of mail fell slightly, relative to 2003. The table below compares unit costs for the two years. Total costs increased from \$64.9 billion in 2003 to \$65.9 billion in 2004, or 1.7 percent. Wage rates and benefit cost inflation was 4.9%, but productivity gains and mix changes offset some of the impact of the inflation. For example, field labor hours decreased by 2.2 percent, despite an overall volume increase of 1.9 percent.

Overall, unit costs fell slightly on average, with First-Class Presort Letters and Standard Regular seeing the greatest declines. In addition, Priority Mail unit costs declined by almost 1 percent, largely due to reduced transportation costs.

First-Class Mail unit costs fell slightly. FCM cost decreases exceeding the fall in volume is an indication that letter mail processing continues to be a strength of the our organization.

Competitive products continue to pay their own way. Express Mail, Priority Mail and Package Services combined to contribute \$2.4 billion to help cover our institutional costs. The total contribution toward the recovery of our \$28.8 billion in institutional costs was \$31.8 billion, which yielded a \$3.1 billion net income.

We enjoyed considerable success in 2004, finding ways to lower unit costs in aggregate. However, we must continue to seek creative solutions to the losses brought on by declining mail volume and rapid network growth.

**COMPARISON OF UNIT COSTS
FY 2003 to FY 2004**

<i>Class of Mail</i>	FY 2003	FY 2004	Percentage Difference
First-Class Mail:			
Single-Piece Letters.....	\$0.252	\$0.252	0.00%
Presort Letters.....	0.098	0.095	-3.06%
Total Letters.....	0.174	0.172	-1.15%
Single-Piece Cards.....	0.183	0.206	12.57%
Presort Cards.....	0.063	0.062	-1.59%
Total Cards.....	0.121	0.129	6.61%
Total First-Class.....	0.171	0.169	-1.17%
Priority Mail.....	3.351	3.319	-0.95%
Express Mail.....	7.533	8.282	9.94%
Periodicals:			
In County.....	0.084	0.083	-1.19%
Outside County.....	0.240	0.260	8.33%
Total Periodicals.....	0.227	0.245	7.93%
Standard Mail:			
Enhanced Carrier Route.....	0.061	0.066	8.20%
Regular.....	0.135	0.131	-2.96%
Total Standard Mail.....	0.109	0.109	0.00%
Package Services:			
Parcel Post.....	2.606	2.643	1.42%
Bound Printed Matter.....	0.809	0.804	-0.62%
Media Mail.....	1.744	1.855	6.36%
Total Package Services.....	1.588	1.603	0.94%
Free Mail (blind, handicapped & military)	0.511	0.518	1.37%
International Mail.....	1.307	1.547	18.36%
Total Mail.....	0.174	0.173	-0.57%