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

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Quarterly Financial Report

For the Three Months and Nine Months Ended June 30, 2004

August 10, 2004

INDEX

PART I. FINANCIAL INFORMATION

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ITEM 1. FINANCIAL STATEMENTS

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

	Three Months Ended June 30, 2004 (unaudited)	Three Months Ended June 30, 2003 (unaudited)
Operating revenue	**$ 16,591**	$ 16,670
Operating expenses:		
Compensation and benefits – Note 5	**12,942**	12,630
Transportation	**1,229**	1,153
Other	**2,117**	2,139
Total operating expenses	**16,288**	15,922
Income from operations	**303**	748
Interest and investment income	**7**	17
Interest expense	**(51)**	(136)
Net Income	**$ 259**	$ 629

See accompanying notes to financial statements.

United States Postal Service
Statements of Operations

(dollars in millions)

	Nine Months Ended June 30,	
	2004 (unaudited)	2003 (unaudited)
Operating revenue	**$ 52,091**	$ 52,140
Operating expenses:		
Compensation and benefits – Note 5	**39,147**	37,670
Transportation	**3,682**	3,650
Other	**6,407**	6,306
Total operating expenses	**49,236**	47,626
Income from operations	**2,855**	4,514
Interest and investment income	**23**	43
Interest expense	**(62)**	(339)
Net Income	**$ 2,816**	$ 4,218

See accompanying notes to financial statements.

United States Postal Service

Balance Sheets – Assets

(dollars in millions)

	June 30, 2004 (unaudited)	Sept. 30, 2003
Assets		
Current assets:		
Cash and cash equivalents	**$ 533**	$ 2,266
Receivables:		
Foreign countries	**655**	744
U.S. Government	**225**	359
Consignment	**54**	50
Other	**148**	144
Receivables before allowances	**1,082**	1,297
Less allowances	**97**	106
Total receivables, net	**985**	1,191
Supplies, advances and prepayments	**348**	366
Total current assets	**1,866**	3,823
Other assets, principally revenue forgone appropriations receivable	**364**	365
Property and equipment, at cost:		
Buildings	**20,098**	19,759
Equipment	**17,256**	17,166
Land	**2,819**	2,809
Leasehold Improvements	**1,117**	1,060
	41,290	40,794
Less allowances for depreciation and amortization	**20,219**	18,717
Construction in progress	**1,428**	977
Total property and equipment, net	**22,499**	23,054
Total Assets	**$ 24,729**	$ 27,242

See accompanying notes to financial statements.

United States Postal Service
Balance Sheets - Liabilities & Net Capital
(dollars in millions)

	June 30, 2004 (unaudited)	Sept. 30, 2003
Liabilities and Net Capital		
Current liabilities:		
Compensation and benefits	**$ 3,836**	$ 2,518
Estimated prepaid postage	**1,349**	1,349
Payables and accrued expenses:		
Commercial Vendors & Other Accrued Expenses	**1,742**	2,269
Foreign countries	**751**	879
U.S. Government	**105**	112
Total payables and accrued expenses	**2,598**	3,260
Permit, metered mail and prepaid box rentals	**1,946**	1,925
Outstanding postal money orders	**783**	768
Debt	**-**	7,273
Total current liabilities	**10,512**	17,093
Non current liabilities:		
Workers' compensation	**7,442**	6,324
Employees' accumulated leave	**2,127**	1,932
Other	**966**	1,027
Total non current liabilities	**10,535**	9,283
Commitments and contingencies - Note 2, 3		
Total Liabilities	**21,047**	26,376
Net capital:		
Capital contributions of the U.S. Government	**3,034**	3,034
Retained Earnings (Deficit) since reorganization	**648**	(2,168)
Total Net Capital	**3,682**	866
Total Liabilities and Net Capital	**$ 24,729**	$ 27,242

See accompanying notes to financial statements.

United States Postal Service
Statements of Cash Flows

(dollars in millions)

		Nine Months Ended June 30, 2004 (unaudited)
Cash flows from operating activities:		
Net Income	$	2,816
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization		1,633
Loss on disposals of property and equipment, net		27
Decrease in other assets		1
Increase in USPS workers' compensation liability		1,094
Increase in employees' accumulated leave		195
Decrease in other liabilities		(61)
Changes in current assets and liabilities:		
Decrease in receivables, net		206
Decrease in supplies, advances and prepayments		18
Increase in compensation and benefits		1,342
Decrease in payables and accrued expenses		(662)
Increase in permit, metered mail and prepaid box rentals		21
Increase in outstanding postal money orders		15
Net cash provided by operating activities		6,645
Cash flows from investing activities:		
Purchase of property and equipment		(1,116)
Proceeds from sale of property and equipment		11
Net cash used in investing activities		(1,105)
Cash flows from financing activities:		
Payments on debt		(7,273)
Net cash used in financing activities		(7,273)
Net decrease in cash and cash equivalents		(1,733)
Cash and cash equivalents at beginning of year		2,266
Cash and cash equivalents at end of period	$	533
Supplemental Data		
Cash paid during the year for Interest	$	19

See accompanying notes to financial statements.

United States Postal Service
Statements of Changes in Net Capital
Nine Months Ended June 30, 2004 and the Year Ended Sept. 30, 2003

(dollars in millions)	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital
Balance, Sept. 30, 2002	$ 3,034	$ (6,036)	$ (3,002)
Net Income	-	3,868	3,868
Balance, Sept. 30, 2003	3,034	(2,168)	866
Net Income–Nine Months Ended June 30, 2004 (unaudited)	-	2,816	2,816
Balance, June 30, 2004 (unaudited)	$ 3,034	$ 648	$ 3,682

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 and nine months ended June 30, 2004 and June 30, 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 2003 Annual Report.

In 2004, we began to prepare interim financial reports on a calendar month basis. Previously, our interim reporting was based on a 28-day, 13 accounting period calendar that had been used since Postal Reorganization. As a result of the conversion to the new reporting periods, 2003 financial data are management's representation of results for the same period last year.

In this report the 2003 appropriations revenue offsetting emergency preparedness expense was reclassified as operating revenue to be consistent with current year presentation (see Note 4).

In the opinion of management, the accompanying unaudited financial statements present fairly our financial position as of June 30, 2004, the results of our operations for the three and nine months ended June 30, 2004, and our cash flows for the nine months ended June 30, 2004.

Note 2. Commitments

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

Capital

At June 30, 2004, we estimate our financial commitment (resources on order) for approved capital projects in process to be $2.3 billion.

Rents

Our total rental expense for the nine months ended June 30, 2004 compared with rental expense for the full year ended September 30, 2003 is summarized as follows:

Rental Expense (dollars in millions)	**For the Nine Months Ended June 30, 2004**	**For the Year Ended Sept. 30, 2003**
Non-cancelable real estate leases including related taxes	**$ 700**	**$ 923**
Facilities leased from General Services Administration subject to 120-day notice of cancellation	**38**	**53**
Equipment and other short-term Rentals	**140**	**201**
Total	**$ 878**	**$ 1,177**

At June 30, 2004, our future minimum lease payments for all non-cancelable leases are as follows.

Future Minimum Lease Payments		
($ in millions)	**June 30, 2004**	
Year	**Operating**	**Capital**
2004	**$ 235**	**$ 20**
2005	**814**	**80**
2006	**784**	**80**
2007	**742**	**80**
2008	**691**	**80**
After 2008	**6862**	**590**
	$ 10,128	**930**
Less: Interest at 4.5 percent		**218**
Total Capital Lease Obligations		**712**
Less: Short-term Portion of Capital Lease Obligations		**11**
Long-term Portion of Capital Lease Obligations		**$ 701**

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 assets in the “Buildings” caption of the Balance Sheet. Capitalized leases at June 30, 2004 were $911 million and $963 million at September 30, 2003. Total accumulated amortization related to capital leases was $276 million at June 30, 2004 and $259 million at September 30, 2003. Amortization expense for capital lease assets is classified as depreciation expense under the “Other” expense caption on the Income Statement.

Note 3. 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 and claims for property damages, and suits and claims arising from postal contracts. We evaluate the materiality of cases determined to have a reasonable chance of adverse outcome. 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.

Note 4. Emergency Preparedness Funding
In October 2001, the United States was targeted by biological terrorism. These activities affected the Postal Service because infectious biological agents were sent by mail. Our viability and our value to the American people are dependent upon maintaining an open and accessible system. Therefore, process changes and technology applications were implemented that can improve the safety of both employees and customers.

The President of the United States authorized an initial funding of $175 million for 2002 to assist in paying for these safety measures. Congress approved two additional appropriations totaling $587 million for emergency expenditures to protect postal employees and customers from exposure to biohazardous material, to sanitize and screen the mail, and to repair or replace postal facilities destroyed or damaged in the 2001 terrorist attacks. Through June 30, 2004, we have spent or committed the $762 million appropriated.

For the nine months ended June 30, 2004, emergency preparedness expenses of $112 million were included in operating expense. Since not all emergency preparedness expenditures qualify under the current appropriations authorization categories, emergency preparedness appropriation revenues of only $81 million were available to offset expenses. These appropriations were classified as operating revenue.

Portions of the emergency preparedness funding received have not yet been recognized as revenue because they have been used to procure biohazard detection and filtration equipment. Appropriation revenues will be recognized over the useful lives of the equipment as it is depreciated. Accordingly, the remaining appropriation balance has been classified as deferred revenue and is included in other accrued expenses on the balance sheet.

Note 5. Civil Service Retirement System Supplemental Liability
As discussed in footnote 7 to the financial statements in the 2003 annual report, the Postal Civil Service Retirement System Funding Reform Act of 2003 (P.L. 108-18) changed our funding of the Civil Service Retirement System (CSRS). Under this Act we are required to pay an additional annual amount each September beginning 2004 if OPM determines that it is necessary. The additional payment amount is based on any supplemental liability resulting from the excess of the actuarial present value of future benefits over the actuarial present value of future contributions, earnings, and other actuarial factors related to postal participants in the CSRS plan. Under multi-employer plan accounting, such amounts will be recognized by us when payable. Also, the potential liability under the new law is variable in nature. Therefore, we are disclosing information on any potential supplemental liability in these notes.

At year-end 2003 we estimated, and OPM confirmed, that the present value of the supplemental liability was $5.8 billion as of September 30, 2003. OPM's revised calculation as of June 30, 2004 of the September 30, 2003 supplemental liability, reflecting actual experience through 2003 and revised assumptions, is $3.5 billion and the annual supplemental liability payment due September 30, 2004 is $240 million.

In 2003 we accrued expense related to the supplemental retirement liability payment of $125 million. Through June 2004, we accrued an additional $55 million. The remaining $60 million will be accrued throughout the remainder of 2004.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

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, 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.

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, heath 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.

RESULTS OF OPERATIONS

Net income in the third quarter was $259 million, compared to $629 million in the corresponding quarter last year. Volume and revenue declined for the majority of the mail classes, with only Standard Mail and International Mail contributing volume and revenue increases. Overall for the quarter, mail volume increased by 2.0 percent, driven almost entirely by Standard and International Mail, and revenue decreased 0.5 percent.

Continuing expense controls and reduced interest expenses helped to restrain total expense growth to 1.8 percent, with operating expense growth of 2.3 percent for the quarter. Most of this increase was in compensation and benefits and fuel price-sensitive non-personnel expense categories, including transportation. These increases were partially offset by continued productivity improvements including workhour and career employee reductions, and reductions in supplies and services costs. But this was not enough to offset a 0.5 percent decline in quarterly operating revenues.

The combined effect of the above is a third quarter operating income of $303 million, which is $445 million less than the third quarter last year, bringing operating income year-to-date to $2,855 million. Table 1 – Summary of Interim Financial Results summarizes the financial results for the three and nine months ended June 30, 2004 with the comparable results for 2003.

Table 1 – Summary of Interim Financial Results

Three Months Ended June 30,			Financial Results	Nine Months Ended June 30,		
2004	2003	%	($ in millions)	2004	2003	%
$ 16,591	$ 16,670	-0.5	Operating revenue	$ 52,091	$ 52,140	-0.1
16,288	15,922	2.3	Operating expense	49,236	47,626	3.4
303	748	NM	Income from operations	2,855	4,514	NM
7	17	-53.0	Interest and investment income	23	43	-45.3
-0	-90	NM	Interest expense on borrowings	-11	-293	-96.5
-51	-46	10.6	Deferred Retirement Interest	-51	-46	10.6
$ 259	$ 629	NM	Net income	$ 2,816	$ 4,218	NM

Note: Percentages are calculated based on unrounded numbers.

Operating Revenue

Revenue growth in Quarter 3 was lower than anticipated in our operating plan, which assumed a pessimistic macro-economic scenario. Despite the improved economic picture, revenue was lower in all categories except for Standard and International Mail.

Standard Mail volume continued to grow in Quarter 3, causing total volume to grow as well. Most of the Standard Mail volume growth has been in the regular automation presort category. Economic growth and increases in advertising spending and corporate profits spurred Standard Mail volume and revenue growth. Standard Mail has also benefited from the “Do Not Call” restrictions. International Mail volume increased in Quarter 3 (included in “Other” in Table 2 – Volume by Class of Mail). That is consistent with indicators of increased international activity such as growing international freight ton-miles. Revenue growth in Standard and International Mail offset declines in other classes of mail for both Quarter 3 and year-to-date revenues.

Volume for First-Class Mail, which is the largest mail class in terms of volume and revenue, declined in Quarter 3 at a more rapid pace than in the previous two quarters. Declining volume and revenues in First-Class Mail reflect the impact of electronic diversion as businesses, non-profit organizations, governments, and households increasingly automate their financial transactions and divert correspondence to the Internet. The volumes of Priority, Express, Package Services, and Periodicals Mail also continued to decline. Priority and Express Mail are losing market share, as is Package Services. Finally, Periodical Mail volume and revenue are declining as businesses and consumers increasingly rely on the Internet as a substitute of hardcopy publication of news, information and entertainment.

Total volumes in the quarter were 2.0 percent above last year; and year-to-date volumes were up 1.4 percent. Operating revenue was 0.5 percent lower for Quarter 3 than for the same three months in 2003. Revenue for the nine months ended June 30, 2004 was 0.1 percent lower than the same nine months a year ago. Although normal business operations at the Postal Service were suspended on June 11, 2004 for the National Day of Mourning in memory of President Reagan, businesses and households continued to generate mail volume resulting in the same number of business days in the economy during Quarter 3 as the same period last year. We saw no noticeable impact on volume.

Table 2 – Volume by Class of Mail and Table 3 – Revenue by Class of Mail provide volume and revenue performance by class of mail.

Table 2 – Volume by Class of Mail

Three Months Ended June 30,			Volume	Nine Months Ended June 30,		
2004	2003	%	(millions)	2004	2003	%
23,520	24,161	-2.7	First-Class Mail	74,261	75,308	-1.4
203	213	-4.8	Priority Mail	650	667	-2.5
14	14	-1.4	Express Mail	41	42	-3.1
2,282	2,353	-3.0	Periodicals Mail	6,909	7,133	-3.1
23,039	21,368	7.8	Standard Mail	71,259	67,922	4.9
245	258	-5.2	Package Services	841	847	-0.7
345	302	14.1	Other	1,083	958	13.3
49,648	48,669	2.0	Total Mail Volume	155,044	152,877	1.4

Note: Percentages are calculated based on unrounded numbers.

Table 3 – Revenue by Class of Mail

Three Months Ended June 30,			Revenue	Nine Months Ended June 30,		
2004	2003	%	($ millions)	2004	2003	%
$ 8,737	$ 9,030	-3.2	First-Class Mail	$27,653	$28,166	-1.8
1,032	1,092	-5.5	Priority Mail	3,401	3,501	-2.9
216	222	-2.5	Express Mail	646	673	-4.1
547	560	-2.4	Periodicals Mail	1,654	1,709	-3.3
4,361	4,066	7.2	Standard Mail	13,489	12,934	4.3
474	498	-4.8	Package Services	1,677	1,702	-1.5
1,224	1,202	1.8	Other	3,571	3,455	3.4
$16,591	$16,670	-0.5	Total Operating Revenue	$52,091	$52,140	-0.1

Note: Percentages are calculated based on unrounded numbers.

Operating Expenses

Workhours

Year-to-date workhour reductions of 21 million provide momentum toward achieving the cost savings planned for 2004. We are implementing plans to continue productivity increases and control expense growth using both cost savings programs and improvements in operational efficiencies with the majority of our savings coming from increases in operational efficiency.

With the exception of rural delivery, year-to-date workhour reductions were achieved across all major functions, including mail processing, distribution, city delivery and administrative functions. Net savings of approximately 2.6 million workhours were realized as a result of the National Day of Mourning in memory of President Reagan (a declared federal holiday) on June 11th. However, these workhour savings were partially offset by additional costs incurred for administrative leave and overtime, thus they do not translate directly into dollar savings. Compared with the end of same period last year, the city delivery function has absorbed the workload associated with an increase of about 450,000 possible deliveries, or 0.5 percent. Rural delivery is the only major function showing a growth in workhours. Initiatives in this area were offset by a 2.9 percent growth compared to this period last year, an increase of 948,000 possible rural deliveries. Year-to-year total possible deliveries have grown 1.1 percent (1.6 million) over 2003, increasing to 142.4 million possible delivery points. Table 4 – Workhours by Function summarizes the workhour utilization in 2004 compared with 2003.

Table 4 - Workhours by Function

Three Months Ended June 30,			Workhours	Nine Months Ended June 30,		
2004	2003	%	(Thousands)	2004	2003	%
			Operations			
2,274	2,323	-2.1	-Operations Support	6,780	6,852	-1.0
80,930	83,499	-3.1	-Mail Processing	256,052	265,616	-3.6
42,996	41,920	2.6	-Rural Delivery	127,621	124,276	2.7
115,157	115,515	-0.3	-City Delivery	348,448	348,973	-0.2
7,913	7,982	-0.9	-Vehicles Services	24,084	24,230	-0.6
20,149	20,419	-1.3	-Plant & Equip Maintenance	61,239	61,574	-0.5
57,442	57,256	0.3	-Customer Services, Retail & Sales	175,622	176,019	-0.2
29,214	35,929	-18.7	Postmasters & Installation Heads, Supervisors, Administration and Other	92,949	106,171	-12.5
356,075	364,843	-2.4	Total Workhours	1,092,795	1,113,711	-1.9

Note: Percentages are calculated based on unrounded numbers.

Compensation and Benefits

Compensation and benefits costs for Quarter 3 were $12,942 million, or 2.5 percent higher than the prior year period. Year-to-date, the increase over the prior year period was $1,477 million, or 3.9 percent. These increases were driven primarily by contractual wage and cost-of-living increases (about $1,200 million) and higher benefit expenses.

Benefit expense increases were due primarily to the required increase in contributions to the CSRS retirement system, from 7 percent to 17.4 percent of CSRS payroll. This higher contribution rate went into effect in May 2003 as a result of Public Law 108-18. We estimate that this higher contribution rate caused year-to-date compensation expenses to be about $612 million higher than they otherwise would have been. In addition to the higher CSRS contributions, higher employee and annuitant health benefits cost, totaling $395 million more than the same nine month period last year, contributed to the overall increase in personnel compensation costs.

Partially offsetting this growth in compensation and benefits costs, the number of career employees, not including the Office of the Inspector General (OIG), was reduced by 3,132 during the quarter and 19,507 year-to-date through attrition and voluntary early retirement opportunities offered to certain employee groups in selected locations.

Table 5 –Compensation and Benefits Expense by Function, on the following page, summarizes personnel compensation cost and compares 2004 compensation cost to that of 2003.

Retiree Health Benefits

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. Our expense related to retiree health benefits was $331 million during this quarter, compared to $293 million in the third quarter of 2003. For the nine months ended June 30, retiree health benefits expenses totaled $991 million, compared to $859 million during the comparable period last year.

Workers' Compensation

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. The accruals are subject to adjustment based on significant variations in claims information provided by OWCP.

Table 5 – Compensation and Benefits Expense by Function

Three Months Ended June 30,			Compensation and Benefits	Nine Months Ended June 30,		
2004	2003	%	($ millions)	2004	2003	%
$ 97	$ 93	4.6	-Operations Support	$ 286	$ 267	7.1
2,747	2,711	1.3	-Mail Processing	8,494	8,322	2.1
1,196	1,122	6.6	-Rural Delivery	3,523	3,294	6.9
4,005	3,834	4.5	-City Delivery	11,989	11,387	5.3
289	278	4.0	-Vehicles Services	867	823	5.4
727	698	4.1	-Plant & Equip Maintenance	2,178	2,058	5.8
1,939	1,859	4.3	-Customer Services, Retail & Sales	5,854	5,552	5.4
1,190	1,331	-10.6	Postmasters & Installation Heads, Supervisors, Administration and Other	3,685	3,834	-3.9
372	364	2.3	Workers' Compensation	1,116	1,115	0.1
331	293	12.8	Retiree Health Benefits	992	859	15.4
49	47	6.2	Other Personnel Compensation	163	159	3.1
$12,942	$12,630	2.5	Total Personnel Compensation	$39,147	$37,670	3.9

Note: Percentages are calculated based on unrounded numbers.

In the third quarter we accrued $372 million in workers' compensation expense, which is $8 million more than last year's third quarter accrual. The year-to-date workers' compensation accrual of $1,116 million is $1 million more than the comparable period last year.

Retirement Expense

The Postal Civil Service Retirement System Funding Reform Act of 2003 (Act) changed the way we fund our Civil Service Retirement System (CSRS) obligation, and transfers to us from the U. S. Treasury the responsibility for funding costs of CSRS benefits that current and former Postal Service employees have earned through military service. The Act also defines "savings" as the difference between contributions we would have made if the Act had not been enacted and the contributions we make under the Act. The Act requires that "savings" after 2005 to be escrowed. According to a 2003 General Accounting Office (GAO) report, without this legislation, we were on course to over-fund our obligation by approximately $105 billion. Without considering the transfer of military service credits, we over-funded our retirement obligations by $10 billion as of September 30, 2002. See our 2003 Annual Report for a full discussion of the other provisions of the Act.

The Act provides an opportunity to reconsider the transfer of the CSRS military service obligation by requiring the Postal Service, Department of the Treasury, and the OPM to submit proposals "detailing whether and to what extent the Department of the Treasury or the Postal Service should be responsible for the funding of benefits attributable to the military service of current and former employees of the Postal Service." In our report we recommended that the responsibility for these costs should be returned to the U. S. Treasury. The GAO prepared a written evaluation (Report Reference: GAO-04-281) of each proposal and submitted its report to the Committee on Government Reform of the House of Representatives and the Committee on Governmental Affairs of the Senate on November 26, 2003.

Postal legislation has been introduced in both the House of Representatives (Postal Accountability and Enhancement Act, H.R. 4341) and the Senate (Postal Accountability and Enhancement Act, S. 2468). Both pieces of legislation provide for the transfer of responsibility for the military service credit back to the Treasury, eliminate the escrow requirement for years after 2005, and provide for the funding of a portion of our postretirement health benefits obligation. As of June 30, 2004, legislation had not been enacted.

Separately, we have taken issue with the methodology OPM used to calculate our CSRS obligations. Specifically, we believe that OPM used an allocation methodology to attribute CSRS pension costs of the pre-July 1, 1971 service that assigns an unreasonably large share of the burden to us for payment. We requested OPM to consider an alternative allocation methodology that is consistent with the approach

OPM previously used to allocate the increase in CSRS pension costs created by annual cost-of-living-adjustments granted to retirees. In accordance with the Act, on January 26, 2004, we filed with the Board of Actuaries of the Civil Service Retirement System a request for reconsideration of the method used by OPM to calculate Postal Service CSRS pension liability. The alternative allocation methodology endorsed in our appeal results in an estimated over funding of Postal Service obligations of $81.6 billion as of September 30, 2002, as opposed to OPM's estimate of $4.8 billion under funding using its new allocation methodology.

Transportation
Transportation expense of $1,229 million is $76 million, or 6.7 percent, over last year's third quarter expense of $1,153 million. Year-to-date, transportation expenses totaled $3,682 million which is $32 million or 0.9 percent over the comparable prior year period. This moderate expense growth, in the face of significantly higher fuel prices was achieved through a variety of network optimization efforts which collectively offset most of the fuel price impacts. Examples of our cost savings efforts include shifting some transportation from commercial air carriers to highway transportation and initiatives to control fuel expenditures.

Significantly higher fuel prices were the major factor contributing to the increase in our transportation expense, and this rise in fuel prices is not offset by fuel surcharges to our customers. The Postal Service uses approximately 800 million gallons of fuel (gasoline, diesel, and jet fuel) each year. A one cent increase in fuel prices, sustained for a year, has an approximate $8 million annual impact on our expenses. During the third quarter, average national retail gasoline prices increased from $1.80 per gallon on March 29, 2004 to $1.921 per gallon on June 28, 2004, according to the U.S. Energy Information Administration. During the corresponding period a year ago, average gasoline prices varied from $1.427 per gallon to $1.577 per gallon.

Supplies and Services and Other Expense
Non-personnel expenses, excluding transportation and interest, of $2,117 million were $22 million (1.1 percent) less than last year's comparable quarter. This reduction was largely attributable to lower depreciation expenses resulting from our scaled-back capital investments in recent years, and reduced or deferred supplies and services expenses. These reductions more than offset increases in rent, fuel and utilities, and vehicle maintenance expenses during the quarter. For the nine month period, non-personnel expenses totaled $6,407 million, which is $101 million or 1.6 percent more than the comparable prior year period. Rent, fuel and utilities, and vehicle maintenance expenses also drove expenses during this longer period; however the reduced depreciation expense was not sufficient to offset these increases.

Interest expense, excluding deferred retirement interest, decreased by $90 million for the quarter and $282 million year-to-date, reflecting both lower average debt balances and borrowing rates. Interest expense year-to-date on our outstanding notes totaled $11 million versus $293 million for this same period last year and was in line with expectations. Without the debt refinancing in 2003, as described in our 2003 Annual Report, outstanding note interest expense for the first nine months of 2004 would have been approximately $274 million.

PRODUCT COST

Annually, the Postal Service prepares 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 2003 was completed and issued in April 2004. The full report is available at http://www.usps.com/financials/cra/welcome.htm, and an analysis of the results is presented beginning at page 17 of our Quarter 2, Financial Report.

PRODUCTIVITY

We use Total Factor Productivity (TFP) to measure the change in the relationship between outputs, or workload, and all the resources used in producing these outputs. Our 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.

Year-to-date workload increased by 0.8 percent, and resource usage declined 1.2 percent, yielding a 2.0 percent increase in TFP. This productivity growth is equivalent to approximately $1,020 million in year-to-date expense reductions. TFP growth has been positive in nineteen of the last twenty quarters. The Quarter 3 workload increase of 0.4 percent was driven primarily by the expanding delivery network, but it was also influenced to a lesser degree by mail volume workload growth. Resource usage decreased 2.5 percent this quarter partially as a result of one less delivery day but also because of decreases in both materials and capital usage.

FINANCIAL CONDITION

Debt and Liquidity

In 2003 we refinanced our debt portfolio, retiring all long-term debt. We currently rely on two credit lines with the U.S. Treasury's Federal Financing Bank. One credit line enables us to draw up to $3.4 billion with two days' notice; the other, up to $600 million on the same business day the funds are requested.

As of June 30, 2004, we had no outstanding debt with the Federal Financing Bank. This represents a reduction of $7.3 billion from both the same period last year as well as year-end 2003. Public Law 108-18 requires that savings realized under its provisions, estimated at $2.7 billion for 2004, be applied to debt reduction. Therefore, debt at September 30, 2004, may not exceed an estimated $4.6 billion. However, the financing plan for 2004 targets debt reduction of $4.2 to $4.7 billion, well beyond the legal requirement. Results through the end of the third quarter suggest that the higher end of the debt reduction target is achievable and may be exceeded.

The first three quarters of our fiscal year typically produce strong cash flow. We used this cash flow and our year-end cash balance to reduce debt. We expect an increase in debt outstanding during the fourth quarter, as we have approximately $1.1 billion in lump sum payments to make for workers' compensation and retirement liabilities. Cash and cash equivalents amounted to $533 million on June 30, 2004, compared to $2.3 billion on September 30, 2003.

Capital Expenditures and Commitments

Capital commitments through the third quarter of 2004 were $1,079 million compared to a plan of $1,168 million. This commitment rate is somewhat slower than projected due to delays in several of the major programs. The program delays are expected to cause a significant reduction in the expected commitments for major equipment purchases during the fourth quarter of 2004. The total 2004 capital commitments are expected to be $1.8 billion versus a plan of $3.2 billion. Delayed commitments for 2004 will be included in the 2005 capital investment plan.

During the third quarter, the Board of Governors approved $328 million in funding for ten projects: Pittsburgh Logistics and Distribution Center; Human Capital Enterprise – Human Resources/Shared Services; Trenton, New Jersey, Processing and Distribution Center Facility Restoration; Mail Processing Infrastructure, Phase 2; Transaction Concentrator Replacement; Airline Receiving Concourse & Trayline System – New York International Service Center; Arlington, Virginia, Main Post Office; Chicago, Illinois Busse Surface Hub; 1,587 Additional Delivery Bar Code Sorter (DBCS) Stacker Modules; Surface Visibility, and Surface-Air Support System (SASS), Phase III.

The capital cash outlays year-to-date were $1,116 million compared with $916 million in 2003. Table 7 – Capital Commitments, Expenditures, and Resources on Order summarizes 2004 activity year-to-date compared to 2003.

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

CAPITAL INVESTMENTS	COMMITMENTS		CASH OUTLAYS		RESOURCES ON ORDER	
($ millions)	Year to Date Through June 30,		Year to Date Through June 30,		June 30,	September 30,
	2004	2003	2004	2003	2004	2003
CONSTRUCTION AND BUILDING PURCHASE	$ 61	$ 37	$ 111	$ 90	$ 174	$ 238
BUILDING IMPROVEMENTS	160	91	185	121	151	187
MAIL PROCESSING EQUIPMENT	596	583	506	460	1,492	1,410
VEHICLES	170	142	92	57	150	72
RETAIL EQUIPMENT	30	51	70	5	139	178
POSTAL SUPPORT EQUIPMENT	61	162	152	183	217	311
TOTAL	$ 1,079	$ 1,067	$ 1,116	$ 916	$ 2,323	$ 2,395

Note: Totals may not sum due to rounding.

SERVICE AND PERFORMANCE

The 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.

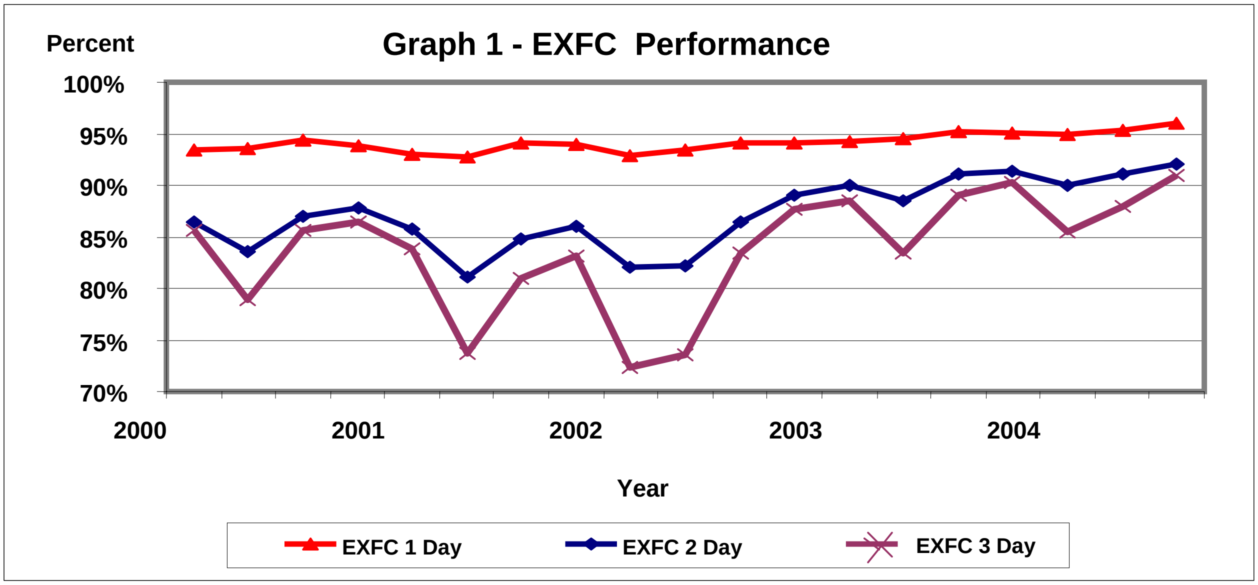
Graph 1 – EXFC Performance, on the following page, summarizes EXFC results by quarter since 2000. Even with the reductions in career employees and workhours, the Postal Service has maintained a high level of service in the 1-day category and improving service for both the two and three day categories. In fact, the highest scores to date were posted this quarter for each of the three measurements. 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 3 showed that 93 percent of these customers rated their experience with the Postal Service as “excellent”, “very good” or “good.”

RATE AND CLASSIFICATION ACTIVITY

The Postal Rate Commission is an independent establishment of the executive branch of the United States government. The Commission reviews our proposals to establish and change domestic mail rates, fees and mail classifications. Upon request by the Postal Service, the Commission holds public hearings and issues recommended decisions to the Governors of the Postal Service, who approve, reject, or, in some cases, modify the Commission’s recommendations. The PRC is also authorized to issue



advisory opinions concerning proposed changes in the nature of postal services that affect service on a 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.

On July 7, 2004, the PRC issued an Opinion and Recommended Decision approving the Stipulation and Agreement establishing an *Experimental Periodicals Co-Palletization Dropship Discounts for High Editorial Publications, PRC Docket No. MC2004-1.* This classification establishes experimental rate categories and discounts for high-editorial content, heavy-weight, small-circulation periodicals mail that is copalletized and dropshipped. The experimental discounts will be available only as an alternative to the existing co-palletization discounts, and are limited to Periodicals mail that has, at most, 15 percent advertising matter, weighs at least 9 ounces per copy, has a mailed circulation of not more than 75,000 copies, and lacks the density to prepare single-publication pallets.

Three classification cases were pending at the end of this quarter. The first classification case is the *Request of the United States Postal Service for a Recommended Decision on Experimental Classification and Rate for Priority Mail Flat-Rate Box, PRC Docket No. MC2004-2*, filed June 3, 2004. The experiment would establish a new classification and flat rate within Priority Mail for matter mailed using specific, Postal Service-supplied Priority Mail box-shaped packaging.

There are also 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*). The NSAs are proposed for Bank One Corporation (*PRC Docket No. MC2004-3*) and Discover Financial Services, Inc. (*PRC Docket No. MC2004-4*).

There are two proposed rulemaking hearings in process. The first concerns defining the term “postal service”, and 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. 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.

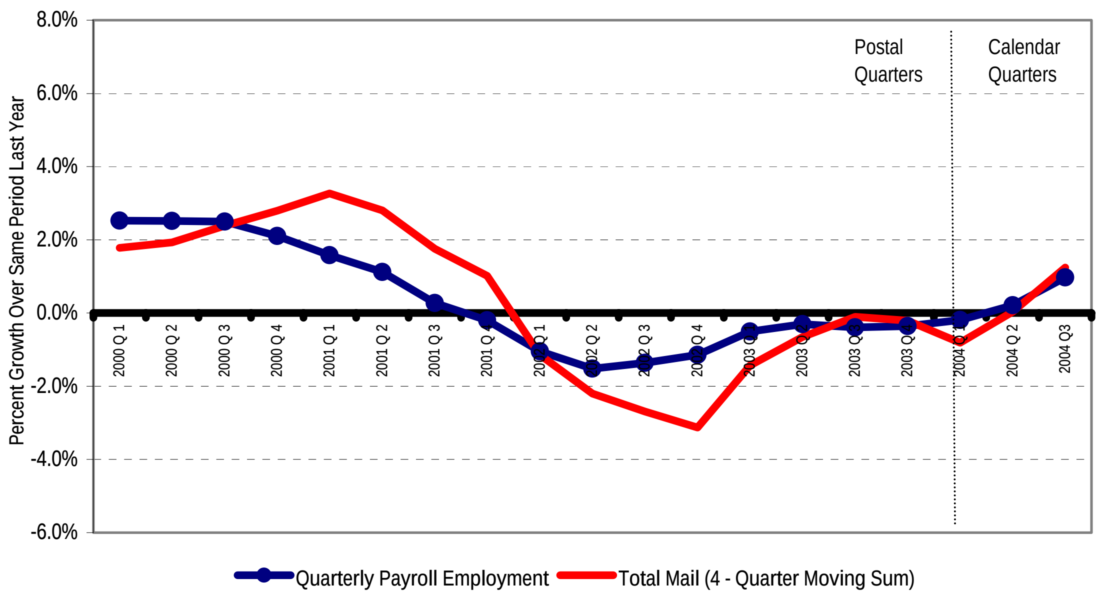
OUTLOOK

Revenue Outlook
Despite the positive economic outlook, revenue for the remainder of the year is expected to be flat to negative in view of the slowed growth in Quarter 3.

Mail volume growth 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, began to pick up in 2003 and has continued to build in 2004. Macroeconomic forecasters Global Insight in their July Baseline Scenario expects GDP to hold at an annualized growth rate around 4 percent for the remainder of the year and projects continued gains in retail sales. However, the rate of growth in retail sales is expected to slow from 5.1 percent in 2004 to 2.7 percent in 2005. Changes in underlying demand and the impact of competitive services will be discussed below.

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. Mail volume growth turned positive in 2004, coincident with employment growth.

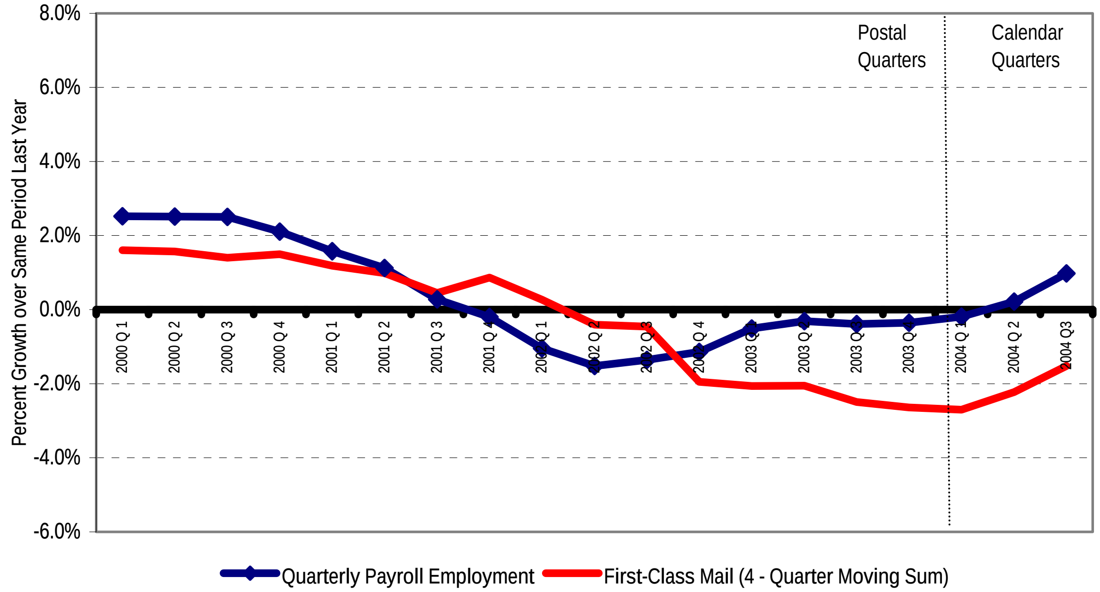
Graph 2
Total Mail Volume and Payroll Employment



Looking forward, Global Insight expects jobs to grow at a sustained rate of 200,000 per month through the rest of 2004 and extending through mid-2005; however, actual payroll employment growth has dropped well below this rate in June and July of this year. Employment growth has a positive affect on total mail volume, but not much affect on total revenue because of mail mix changes, which, as noted above, 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 in relation to payroll employment. First-Class Mail continues to decline despite increased employment and strengthened economic growth. Economic growth has only attenuated the declines in First-Class Mail volume and revenue because technological alternatives to mail are negatively impacting the demand for First Class Mail. The Postal Service is not projecting a reversal of the multi-year downward trend in First-Class volume.

Graph 3
First-Class Mail Volume and Payroll Employment



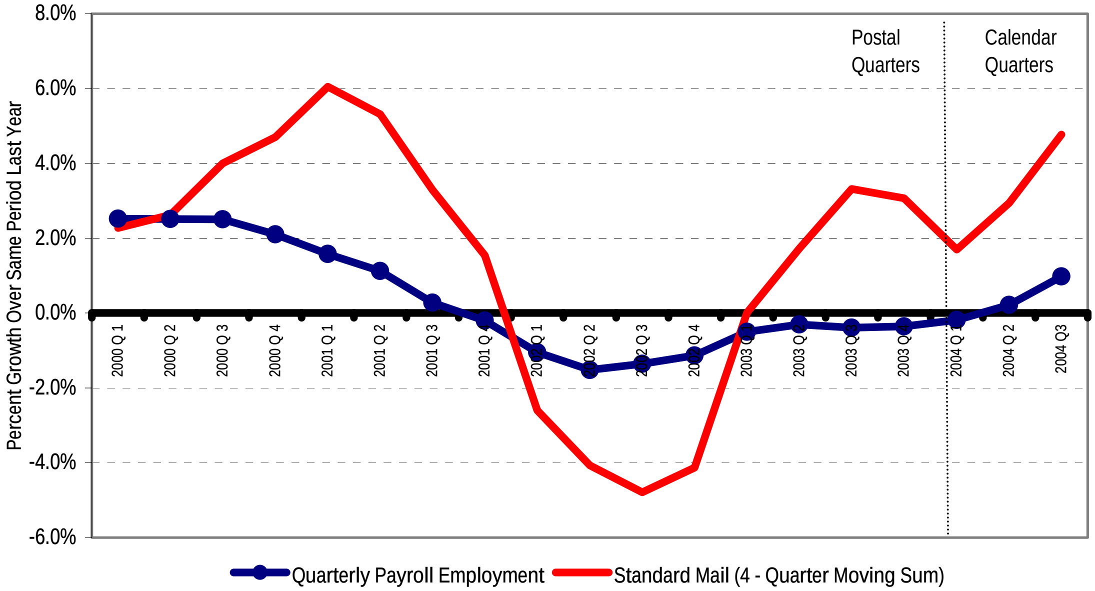
We project strong Standard Mail volume growth to continue through the remainder of the year and into early next year due to the positive economic outlook, the boost that Standard Mail is receiving from "Do Not Call" telemarketing restrictions and the increase in political mailings in the run-up to the election. As Graph 4 – Standard Mail Volume and Payroll Employment shows, Standard Mail is growing more rapidly than the payroll indicator. We expect Standard Mail volume and revenue to finish above the annual operating plan projection despite having been well short of the operating plan projection in the first quarter.

With continued heightened competition, we expect Priority Mail and Express Mail market share declines to continue. Also, our Package Services volume growth is weakening and the decline in Periodicals Mail volume is expected to continue. However, we are changing the short term outlook for International Mail. Based on the past three quarters of data, we expect International volume and revenue to grow for the remainder of the year.

In total, we expect to finish the year close to the annual operating plan revenue projection of $68,906 million.

Expense Outlook
The outlook for the last quarter of FY 2004 is for a continuation of the restrained expense increases we have witnessed in the first three quarters. Our total expense plan for 2004 is $66,796 million, which represents 2.9 percent growth over 2003. Year-to-date total expenses through Quarter 3 are $590 million below plan and have grown only 2.8 percent compared to the same period last year. The outlook for achieving our targeted $1.4 billion in cost savings for the year remains good.

Graph 4
Standard Mail Volume and Payroll Employment



While there continues to be some risk of accelerated inflation, our greatest exposure to inflation is in salary and benefits, and this risk relates primarily to 2005. The next set of COLA adjustments for craft personnel occurs in September and will have little impact on 2004 results. Likewise, health benefits premiums for postal employees and retirees will not increase again until January 2005.

The current high level of fuel costs and the potential for further increases remains a concern. We do not hedge any costs, thus we are exposed to market price fluctuations. Although fuel prices have moderated recently, they remain relatively high. Currently, we estimate that transportation costs for the year will be at or below last year's level; however, this projection could be problematic if the current high levels of fuel costs increase further for the remainder of the year. In addition to transportation, increased energy costs would negatively affect a variety of other nonpersonnel items, including utility expenses, vehicle servicing costs and rural carrier equipment maintenance allowances.

As discussed in the Operations section and our 2003 Annual Report, the Postal Civil Service Retirement System Funding Reform Act of 2003 changed our funding requirements for CSRS retiree benefits. As required by the Act, we have submitted reports giving our recommendations on two issues. First, we recommended that the obligation to fund the military service costs of postal employees' CSRS retirement benefits revert to the Department of the Treasury. Second, we recommended that the escrow provisions of the Act be eliminated and that the "savings" be used to fund retiree health care benefits, retire debt or fund capital expenditures. We do not know what actions, if any, will be taken regarding these proposals. Any of these issues could materially affect our financial results in 2004 and beyond.

This quarter we received OWCP workers' compensation claims data for the nine months ending March 31, 2004. The claims data indicate a downward trend in the number and cost of certain cases. If this trend continues through the final OWCP claims processing quarter, the 2004 workers' compensation cost accrual will be reduced. In addition to this change in case data, our actuaries recommended that we evaluate the approach for determining and validating the discount rates used to calculate the present value of future workers' compensation claims payment projections. This evaluation will be completed in the fourth quarter and any changes to these discount rates may impact the accrued workers' compensation liabilities and expense.

In accordance with our Emergency Preparedness Plan, the Board of Governors approved the Biohazard Detection System and the Ventilation and Filtration System, a commitment of $573 million. We have scheduled deployment of these systems to begin in 2004 and to be completed by mid-2005. We have requested a $350 million Congressional appropriation for 2004, which has not yet been authorized. Failure to receive this appropriation will impact future financial results.

In total, absent unforeseen events, we expect to finish 2004 below the annual expense plan budget of $66,796 million.

FORWARD LOOKING STATEMENTS

The "Management 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.

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. 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 June 30, 2004.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note 3, Contingent Liabilities, June 30, 2004 financial statements.

ITEM 5. OTHER INFORMATION

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.

U.S. Postal Service Delivery At An All-Time High
July 22, 2004 - News Release #04-051

USPS Boosts Productivity, Holds Rates Steady
July 20, 2004 - News Release #04-050

U.S. Postal Service Board Of Governors To Meet In San Francisco, July 19-20, 2004
July 13, 2004 - News Release #04-0486t5

USPS Files BankOne And Discover Proposals
June 21, 2004 - News Release #04-044

Postal Governors Approve Major Capital Projects
June 15, 2004 - News Release #04-043

Priority Mail Flat-Rate Box Proposed
June 11, 2004 - News Release #04-041

Biohazard Detection System Deployment Resumes
June 4, 2004 - News Release #04-038

U.S. Postal Service Board Of Governors To Meet In Washington, DC, June 15, 2004
June 3, 2004 - News Release #04-037

U.S. Postal Service Scores 95 Percent Sixth Quarter In A Row
May 12, 2004 - News Release #04-031

U.S. Postal Service Board Of Governors Statement On Postal Reform
May 12, 2004 - For Immediate Release

Board Of Governors To Meet May 11-12, 2004 In Dallas
May 4, 2004 - News Release #04-030

Biohazard Detection System Deployment Delayed
April 28, 2004 - News Release #04-029

Board Of Governors To Meet In Washington, D. C. April 15, 2004
April 5, 2004 - News Release #04-021

ITEM 6. EXHIBITS AND REPORTS

None.