United States Postal Service Annual Report 2005

Everywhere,
Every day

Neither snow

Nor rain

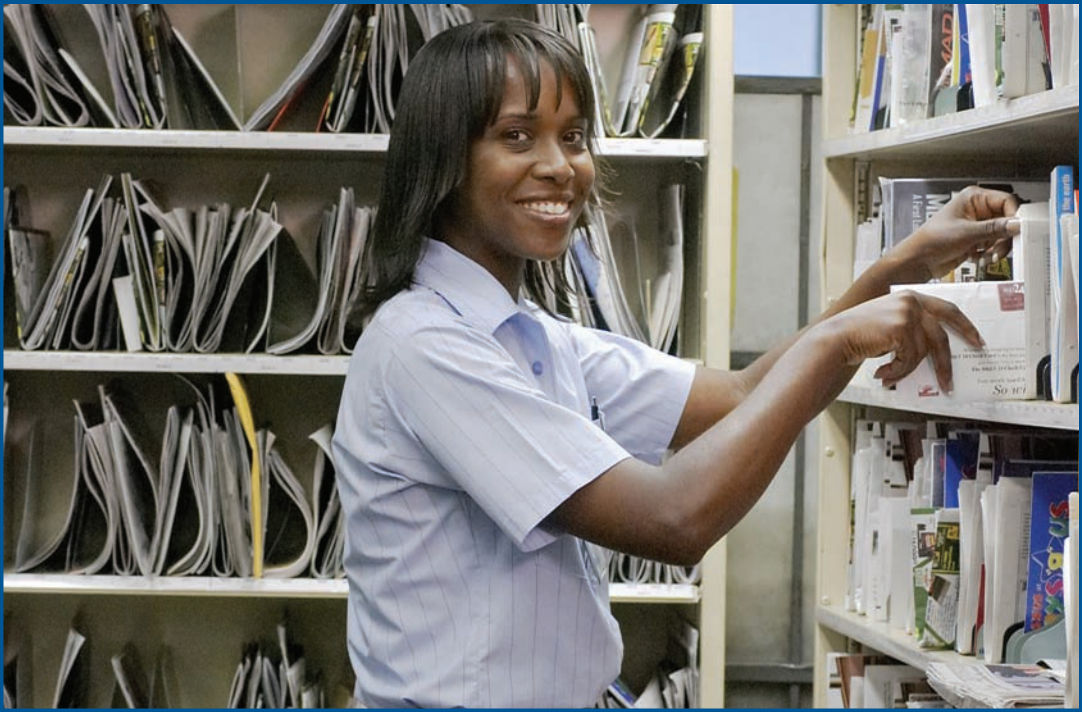

LABEL
OTHER
END
LABEL
OTHER
END
UNITED STATES
POSTAL SERVICE

Nor heat

Nor gloom of night

Nor hurricanes

Nor floods



Stays these couriers

From the swift completion

Of their appointed rounds

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Financial highlights

(Dollars in millions)	Year Ended September 30,			Percentage Change From Preceding Year		
	2005	2004	2003	2005	2004	2003
Operating revenue	$ 69,907	$ 68,996	$ 68,529	1.3%	0.7%	3.1%
Operating expenses	$ 68,283	$ 65,851	$ 63,902	3.7%	3.0%	(2.0%)
Income from operations	$ 1,624	$ 3,145	$ 4,627			
Operating margin	2.3%	4.6%	6.8%			
Net income	$ 1,445	$ 3,065	$ 3,868			
Cash outlays for purchase of capital property and equipment	$ 2,317	$ 1,685	$ 1,314	37.5%	28.2%	(22.9%)
Total debt	$ –	$ 1,800	$ 7,273	(100.0%)	(75.3%)	(34.6%)
Interest expense*	$ 2	$ 10	$ 334	(80.0%)	(97.0%)	(1.8%)
Capital contributions of U.S. government	$ 3,034	$ 3,034	$ 3,034			
Retained earnings (deficit) since reorganization	$ 2,342	$ 897	$ (2,168)			
Total net capital	$ 5,376	$ 3,931	$ 866			
Number of career employees	704,716	707,485	729,035	(0.4%)	(3.0%)	(3.2%)
Mail volume (Pieces in millions)	211,743	206,106	202,185	2.7%	1.9%	(0.3%)
New delivery points served**	2,006,577	1,782,900	1,908,797			

* Excluding interest expense on retirement obligations.
** See page 35 in our Management's Discussion and Analysis for a description of a change we made in 2004 in how we count delivery points.

Year in review

Delivering Our Best

Outstanding service is nothing new for the Postal Service. For the second straight year, on-time delivery of overnight-committed First-Class Mail reached 95 percent, as independently measured by IBM Consulting Services. In quarter 3, this score grew to 96 percent.*

Satisfying Customers

Delivering value — great service, affordable prices, and ease-of-use — is the winning formula for pleasing customers. Independently measured customer satisfaction scores show that 94% of residential customers rated their experience with the Postal Service as excellent, very good, or good. And we're experiencing steady improvement in "excellent" and "very good" ratings.

Keeping Our Promise

With the implementation of the *Transformation Plan* in 2002, we pledged to remove $5 billion in costs from our system by the end of 2006. We met that commitment a full year ahead of schedule. It's our goal to cut another $5 billion through 2010, continuing to make mail a better value than ever.

Helping Others

Our *Breast Cancer Research* stamp — the Postal Service's first semipostal stamp — has raised $48.9 million to help find a cure. The *Heroes of 2001* semipostal has raised $10.6 million for the families of emergency workers killed or injured in the 9/11 attacks. And the *Stop Family Violence* semipostal has raised $1.8 million for the victims of this form of abuse.

Extending Hours

Our customers are busy with work, school, family and, of course, all the chores that go with that. Their time is limited. So we're making it easy for them to get to the Post Office by extending hours — in the evening and on weekends — at thousands of Post Offices from coast to coast.

Protecting Consumers

The Postal Inspection Service worked to protect American consumers from fraud. In partnership with other agencies, Postal Inspectors launched "Operation Dialing for Dollars," to shut down fraudulent telemarketers, particularly those who target older Americans. Investigations resulted in 64 arrests and 64 convictions. Postal Inspectors also continued their successful efforts to combat child pornography.

Closing the Sale

Direct mail is the fastest growing segment of the advertising market, increasing at twice the rate of any other media. That's because direct mail stands out in a crowded selling environment, with the ability to offer a personalized message to just the audience you want to reach.

Bringing the Post Office to Your Home or Office

We continue to add new features to our online Post Office, *usps.com*, making it more valuable than ever — features like insurance, return receipts, change-of-address, and mail-hold requests. That's in addition to *usps.com's* powerful combination of Click-N-Ship, for address labels and postage, and Carrier Pickup online notification, to alert your letter carrier to pick up your prepaid Priority or Express Mail package from your home or office with the next day's delivery — at no extra charge!

Keeping People Connected

Following the unprecedented devastation of Hurricanes Katrina and Rita, the Postal Service worked to keep evacuees connected with friends and loved ones — through the mail. Temporary Post Offices were set up in shelters throughout the nation. Where normal delivery was impossible, special arrangements were made for the distribution of Social Security checks. And mail was forwarded for more than 600,000 households in the affected areas of Florida, Alabama, Mississippi, Louisiana, and Texas.

Increasing Efficiency

Postal efficiency continued its upward swing, with an unprecedented sixth consecutive year of growth in total-factor productivity — the equivalent of more than $700 million in cost savings.

Building a Safer Workplace

Innovative new partnerships with postal employees, their unions and the Occupational Safety and Health Administration have resulted in a safer workplace. Through OSHA's Voluntary Protection Program and Ergonomics Risk Reduction Program, accidents have been dramatically reduced at participating sites. Overall, injuries and illnesses declined by an impressive 11.9 percent, supported by the development a strong culture of safety throughout the entire organization.

Caring for Others

Postal employees from coast to coast collected a record 71.3 million pounds of food, almost a half-million pounds more than last year, during the 13th annual Postal Service/National Association of Letter Carriers "Stamp Out Hunger" Food Drive — the nation's largest one-day effort to combat hunger. The food was distributed to local food banks, pantries, and shelters to help needy families.

* The External First-Class Mail measurement system (EXFC) measures collection box to mailbox delivery performance. EXFC continually tests a panel of 463 ZIP Code areas selected on the basis of geographic and volume density from which 90% of First-Class Mail volume originates and 80% destinates. EXFC is not a system-wide measurement of all First-Class Mail performance.

Your time is valuable. That's why we created Automated Postal Centers. Just about anything you can do at the counter, you can do from an APC. They're in hundreds of Post Offices nationwide, with many available 24/7! >


Global Priority Mail
4–6 business day delivery.**
$4.00 and up
Insurance
Insured against loss or damage up to $5,000.
*Also available on international mail.
$1.30 and up
RICHARD
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Quick Tip

A Letter from the Postmaster General/CEO and the Chairman of the Board of Governors

John E. Potter and James C. Miller III

To the President, Members of Congress, Postal Employees, and the American People:

The United States Postal Service achieved remarkable results in 2005. As we began the year, our projections called for a net loss of $200 million. By the time we closed the books, we had achieved a net income of $1.4 billion.

This reflects the strong efforts throughout the entire organization to remain focused on the transformational strategies we identified in 2002.

We continued to improve operational efficiency. A strong emphasis on results helped us to achieve a record sixth consecutive year of growth in total factor productivity, resulting in the equivalent of more than $700 million in cost savings. This contributed to our ability to deliver on our five-year commitment to reduce costs by $5 billion, a full year ahead of schedule. We eliminated all outstanding debt by mid-year, down from $11.3 billion in Fiscal Year 2002.

We saw significant growth in mail volume — to nearly 212 billion pieces, an increase of 6 billion pieces from 2004 — by continuing to add value for our customers. New products, innovative features, and record levels of performance drove growth in Standard Mail and Package Services, enough to offset the decline in higher-contribution, single-piece First-Class Mail.

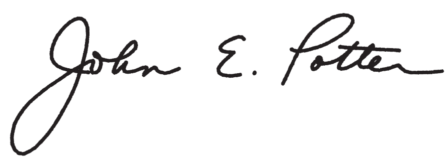
We continued to enhance our performance-based culture. Employees at every level of the organization — from carriers to retail employees to Postmasters and station and branch managers — reached out to their customers and communities to promote the value of the mail. Their efforts were supported by award-winning marketing efforts that highlighted the quick, easy, and convenient shipping and mailing solutions offered by the Postal Service.

While we were faced with significant cost growth, including the price of fuel and the expansion of our delivery network by more than 2 million new homes and businesses, we were able to absorb these increases and hold postage rates steady for a third straight year. However, an impending escrow payment obligation of $3.1 billion resulting from legislation enacted in 2003 made it necessary to file for an across-the-board rate increase of 5.4 percent to be effective in early 2006.

Looking ahead, the Postal Service recognized that it had to plan for the challenges of a continually changing marketplace. This resulted in the creation of the *Strategic Transformation Plan 2006-2010.* Developed with the input of customers and employees, it builds on our 2002 Transformation Plan, and explains how we will intensify our efforts to stay focused on our core business and pursue the strategies that we know produce results.

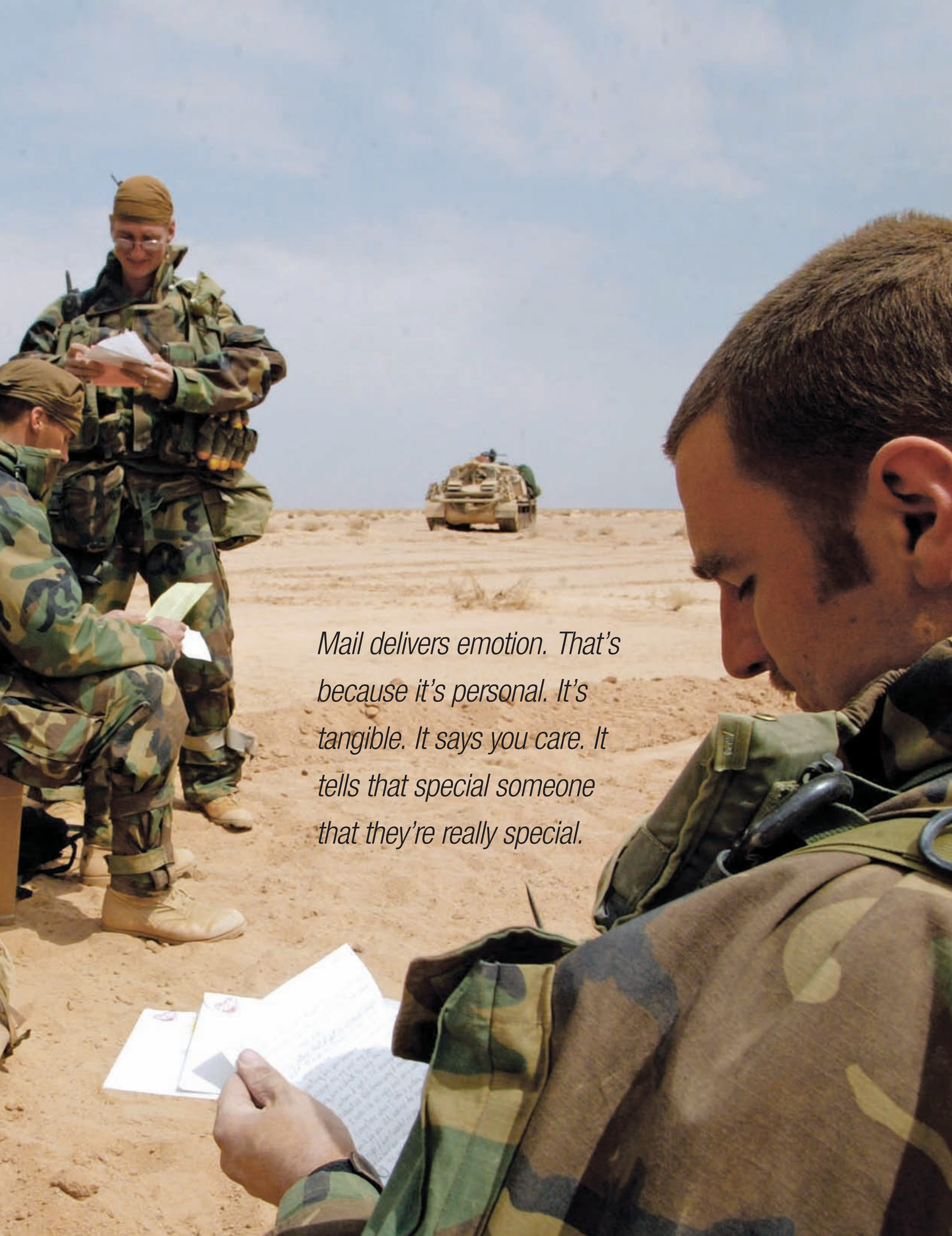
As we ended the year, the tragic devastation of Hurricanes Katrina and Rita served as reminders of the important role the Postal Service plays in the life of our nation. Despite their own hardships, postal employees through the entire Gulf coast area worked tirelessly to keep people connected through the mail with friends and loved ones. They made sure mail reached evacuees wherever they were — in shelters, in devastated communities, or in temporary locations hundreds and thousands of miles from home.

We could not be prouder of the men and women of the Postal Service.



John E. Potter
Postmaster General, Chief Executive Officer

James C. Miller III
Chairman, Board of Governors



Mail delivers emotion. That's because it's personal. It's tangible. It says you care. It tells that special someone that they're really special.

It’s about being the best

That’s the vision of your Postal Service. That’s our plan. And it’s backed by the performance and customer focus of 700,000 men and women serving you in every community from coast to coast.

Over three years ago, we set out to transform the Postal Service. In a changing and ever-more-competitive communications market, the Postal Service had to change, too. We had to become more efficient than ever. We had to make sure our products and services offered the best value possible for our customers. And performance had to become the watchword for everyone in the organization.

The results are in. Our efforts kept productivity on an upward path. We’ve delivered on our promise to reduce costs. We’ve wiped out our debt. We’re delivering fifty percent more mail to 32 million more homes and businesses than we did 20 years ago — and we’re doing it at 1985 staffing levels. We’ve introduced new products, services and features that meet the needs of our customers. We’ve expanded access — making it easier than ever to do business with the Postal Service. We’ve pushed service to record levels. And that’s reflected in record customer satisfaction scores. Add it all together, and mail offers the value our customers are looking for. That’s resulted in revenue growth and increasing mail volumes.

Looking ahead, our plan is to intensify our efforts. We know what works. The same strategies that delivered today’s success are at the core of our new *Strategic Transformation Plan* that will guide us over the next five years. It is our blueprint for the future, to help us anticipate and respond to changing customer needs, market requirements and technological developments.

We will continue to reduce costs by improving efficiency in all our operational and business practices. We will bring the value of our service to even higher levels. We will use the best technology to make the mail a rich source of information, both for our customers and our managers. We will continue to promote growth by creating more value for every customer. And we will achieve these goals with a fully engaged workforce that understands customer needs and meets customer expectations.

It’s all about being the best — the best value in the marketplace, the largest, best run communications and delivery service in the world, and, for our employees, the best place to work.

That’s our vision. And the entire organization is focused on achieving it.

The United States Postal Service will continue to reduce costs by improving efficiency in all our operational and business practices. We will bring the value of our service to even higher levels.

Nothing delivers like the mail

Even in today's wired world, mail delivers — like nothing else can. And no other medium does it all — or does it as well.

Whoever you're trying to reach, for whatever reason, mail does the job. Whether your audience is one in a million or millions at once, whether it's your Generation X daughter or your retired grandfather. Mail is the right solution.

Mail delivers emotion. It says you care. It tells that special someone that they're really special. It can be a card. A package. Or just a quick note. It's from you, personally. A tangible expression that you're thinking of them when they laugh at your postcard, cheer up with your get well wishes or share the pride in a young one's graduation.

Mail delivers attention. Today's families welcome mail into their homes and set aside a special time to look at it. It doesn't interrupt dinner or a TV show. It's an important part of every day, letting you reach who you want, when you want.

Mail delivers results. That's why direct mail is the leading media choice of advertisers. It's effective and measurable. People act on it — they take a flyer to the store, they buy online from a featured website.

Mail delivers convenience. Packages are just one example. Businesses and retailers can mail packages to every household in America. More than 114 million addresses with no residential surcharges. And households can ship packages from their doorstep, too — to anywhere in the world using our enhanced package service offerings and tracking capabilities.

Mail delivers worldwide reach. We touch every address in the country and millions more around the globe. With more than 37,000 Post Offices, mail is supported by the nation's largest retail network. Add our popular website, *usps.com*, and just about every computer in every home and every office becomes your personal Post Office — your gateway to the world.

Person to person. Business to business. Door to door. Hand to hand. That's the power that mail delivers. There's nothing else like it.

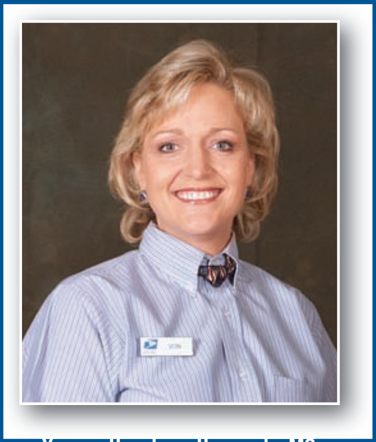
Mail delivers — like nothing else can. And no other medium does it all — or does it as well.

Postal Service Ambassadors

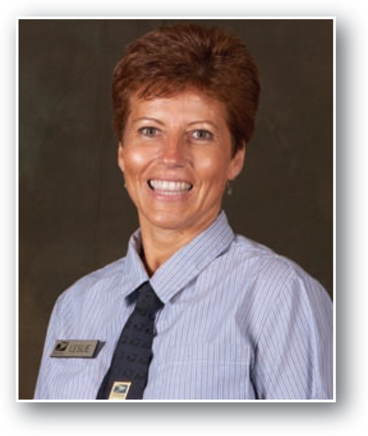
Our retail sales associates join our letter carriers and customer service employees as Postal Service ambassadors, telling the world about our quick, easy and convenient products and services.

Benjamin Carter, Fairfax, VA

Borys Dudar, Brooklyn Park, MN

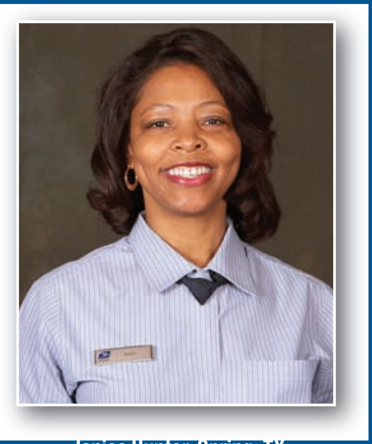


Yvonne Hanshew, Hernando, MS



Leslie Hearn, Brewerton, NY

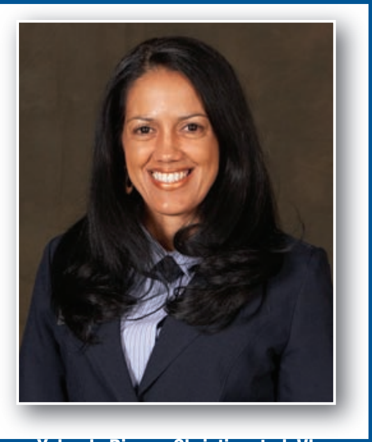
Arthur Holland, Dayton, OH



Janice Hunter, Spring, TX

Sharra Klienbenstein, Carlsbad, CA

Steven Refinski, Appleton, WI



Yolanda Rivera, Christiansted, VI

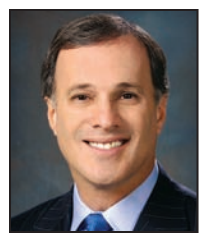
Board of Governors

As the governing body of the Postal Service, the 11-member Board of Governors has responsibilities comparable to a board of directors of a publicly held corporation. The Board is composed of nine Governors appointed by the President of the United States with the advice and consent of the Senate. Not more than five Governors may be members of the same political party. The other two members of the Board are the Postmaster General and the Deputy Postmaster General. The Governors appoint the Postmaster General, who serves at their pleasure without a specific term of office. The Governors, together with the Postmaster General, appoint the Deputy Postmaster General.

The Board meets on a scheduled basis and, at the annual meeting in January, the Chairman and the Vice Chairman are elected by the Governors from among all members of the Board.

The Board directs the exercise of the power of the Postal Service. It establishes policies, basic objectives, and long-range goals for the Postal Service in accordance with Title 39 of the United States Code. The Governors are authorized to establish reasonable and equitable classes of mail and reasonable and equitable rates of postage and fees for postal service. A specific power reserved by statute for the Governors alone is to approve, allow under protest, reject or, by unanimous written decision, modify recommended decisions of the Postal Rate Commission on postal rate and mail classification changes.

James C. Miller III, Chairman Appointed April 2003. Term expires December 2010. Member, Audit and Finance Committee. Chairman emeritus, The CapAnalysis Group; Senior Fellow, Hoover Institution at Stanford University; Former Director, U.S. Office of Management and Budget; Former Chairman, U.S. Federal Trade Commission.



Alan C. Kessler, Vice Chairman Appointed November 2000. Term expires December 2008. Chairman, Strategic Planning Committee. Attorney and entrepreneur; Partner, Wolf, Block, Schorr and Solis-Cohen, LLP; Member, Board of Directors, Philadelphia Industrial Development Corporation; Chairman, Pennsylvania Supreme Court Continuing Legal Education Board.

LeGree S. Daniels Appointed August 1990. Reappointed November 1999. Served until her death in November, 2005. Member, Capital Projects Committee. Former Assistant Secretary for Civil Rights, U.S. Department of Education; Former member, U.S. Civil Rights Commission; Former member, Board of Directors, Center for International Private Enterprise; and member, Board of Directors, Heinz Center.

Robert F. Rider Appointed May 1995. Term expired December 2004, serving a statutorily permitted one-year hold over. Served as Chairman, January 2001 through December 2002. Served as Vice Chairman, January 1999 through December 2000. Chairman, Audit and Finance Committee. Chairman and CEO, O.A. Newton & Son Co.; Trustee, University of Delaware and Wilmington Medical Center; Director of numerous companies and institutions.

Louis J. Giuliano Appointed November 2004. Term expires December 2014. Chairman, Capital Projects Committee, Member, Audit and Finance Committee; former Chairman of the Board of Directors of ITT Industries and former President and Chief Executive Officer; Director of The ServiceMaster Company; Honorary Chairman of the Westchester County Red Cross Armed Forces Emergency Services.

Carolyn Lewis Gallagher Appointed November 2004. Term expires December 2009. Member, Strategic Planning Committee; Member of the President's Commission on the U.S. Postal Service; Former President and Chief Executive Officer of Texwood Furniture, Inc.; a Trustee and the immediate past chair of the board of St. Edward's University; and a Trustee of the Texas Employees Retirement System.

John E. Potter Appointed 72nd Postmaster General and Chief Executive Officer of the United States Postal Service in June 2001. Potter has served as Chief Operating Officer and Executive Vice President; Senior Vice President, Operations; Senior Vice President, Labor Relations; and Manager, Capital Metro Operations.

Patrick R. Donahoe Appointed 19th Deputy Postmaster General in April 2005, Donahoe is Chief Operating Officer and has served as Senior Vice President, Operations; Senior Vice President Human Resources; and Vice President, Allegheny Area Operations.

The Executive Committee

The Executive Committee of the United States Postal Service consists of the Postmaster General, the Deputy Postmaster General and Chief Operating Officer, the Chief Financial Officer, the Executive Vice Presidents of Human Resources, and Marketing, the Senior Vice President of Government Relations, the General Counsel, and the Vice President of Strategic Planning. The Executive Committee is a decision-making body and its members serve as senior advisors to the Postmaster General. It meets frequently and as necessary to consider topics of importance to the Postal Service.

John E. Potter
Postmaster General and CEO

Patrick R. Donahoe
Deputy Postmaster General and Chief Operating Officer

Anita J. Bizzotto
Chief Marketing Officer and Executive Vice President

Richard J. Strasser, Jr.
Chief Financial Officer and Executive Vice President

Anthony J. Vegliante
Chief Human Resources Officer and Executive Vice President

Mary Anne Gibbons
Senior Vice President and General Counsel

Thomas G. Day
Senior Vice President Government Relations

Linda A. Kingsley
Vice President Strategic Planning

Leadership of the U.S. Postal Service

Nicholas F. Barranca Vice President, Product Development
Sylvester Black Vice President, Area Operations (Western)
Charles E. Bravo Senior Vice President, Intelligent Mail and Address Quality
Megan J. Brennan Vice President, Area Operations (Northeast)
William J. Brown Vice President, Area Operations (Southeast)
Ellis A. Burgoyne Vice President, Delivery and Retail
James A. Cohen Judicial Officer
Jo Ann Feindt Vice President, Area Operations (Great Lakes)
William P. Galligan Senior Vice President, Operations
DeWitt O. Harris Vice President, Employee Resource Management
Lee R. Heath Chief Postal Inspector
Alfred Iniguez Vice President, Area Operations (Pacific)
Azeezaly S. Jaffer Vice President, Public Affairs and Communications
Stephen M. Kearney Vice President, Pricing and Classification
Delores Killette Vice President, Consumer Advocate
Susan M. LaChance Vice President, Employee Development and Diversity
Jerry D. Lane Manager, Capital Metro Operations
Keith LaShier Vice President, Facilities (Acting)
Alexander Lazaroff Vice President, Area Operations (Eastern)
George L. Lopez Vice President, Area Operations (Southwest)
Lynn Malcolm Vice President, Controller
Walter F. O'Tormey Vice President, Engineering
Robert L. Otto Vice President, Chief Technology Officer
Henry A. Pankey Vice President, Emergency Preparedness
Robert J. Pedersen Vice President, Treasurer
Susan Plonkey Vice President, Customer Service
David L. Solomon Vice President, Area Operations (New York Metro)
Mike Spates Vice President, Consumer Advocate (Acting)
A. Keith Strange Vice President, Supply Management
Douglas A. Tulino Vice President, Labor Relations
Paul Vogel Vice President, Network Operations Management
James P. Wade Vice President, International Business
Jerry W. Whalen Vice President, Sales

A Message from the Audit and Finance Committee


Robert F. Rider

The Audit and Finance Committee monitors Postal Service's financial reporting and internal control procedures to ensure compliance with best corporate practice, promote good governance and enhance transparency.

The Audit and Finance Committee assists the Board of Governors in fulfilling its fiduciary responsibilities. The Chairman of the Board selects the members of the Committee for each calendar year. Board Chairman James C. Miller, Governor Louis J. Giuliano, and I are the current members of the Committee. The certified public accounting firm responsible for the independent audit of Postal Service financial statements, Ernst & Young, LLP, reports to the Board through the Committee. The Postal Service Inspector General reports to the Governors and is represented at all Committee meetings.

The Committee monitors financial performance, debt levels and cash management on an ongoing basis. When omnibus rate changes are required, the Committee monitors management's development of rate case filings. Fulfilling its primary responsibility, oversight of the integrity of Postal Service financial statements, the Committee periodically reviews the soundness of internal accounting and control practices and major financial statement estimates and accruals.

The Committee met in Washington D.C. four times in 2005. The Committee also held a meeting by conference telephone call on one occasion. During the year, the Committee updated its charter; reviewed methodologies for attributing cost and estimating revenue by class of mail; discussed issues concerning the integrated financial plan for 2006; and reviewed the development of the Office of the Inspector General's work plan for 2006.

The Committee monitors Postal Service's financial reporting and internal control procedures to ensure compliance with best corporate practice, promote good governance and enhance transparency. The Committee was kept advised of the accelerated production of Postal Service financial statements to comply with a Federally mandated submission of the statements to the Office of Management and Budget by November 18, 2005. This was an area of major accomplishment in 2005. This enhancement follows major changes to reporting schedules and formats initiated in 2004. The Postal Service adopted monthly reporting and began SEC-type financial reporting in formats similar to 8-K, 10-K and 10-Q reports. These improvements in the timeliness and transparency of the Postal Service financial reports flow directly from specific recommendations of the President's Commission on the United States Postal Service. These reports, as well as current and historical reports on revenues, volumes, costs and annual financial plans are posted on usps.com, the Postal Service's universal access web site. The Postal Service continues to meet the voluminous reporting requirements of the Postal Rate Commission, Congress, the Government Accountability Office, the federal Office of Personnel Management, and the Office of Management and Budget.

In directing the conduct of the 2005 financial statement audit, the Committee met with Ernst & Young, LLP, and concurred with the scope and materiality levels they established in their work plan for the task. The Committee met jointly and independently with Ernst & Young, LLP, the Inspector General, management and the General Counsel to discuss the progress of the audit and ensure independence and objectivity in the audit programs.

Accordingly, the Committee recommended, and the Board approved, the financial statements for 2005.

Robert F. Rider
Chairman, Audit and Finance Committee
December 6, 2005

The Postal Service continues to meet the voluminous reporting requirements of the Postal Rate Commission, Congress, the Government Accountability Office, the federal Office of Personnel Management, and the Office of Management and Budget.

A Message from the Chief Financial Officer and Executive Vice President

Richard J. Strasser, Jr.

As is widely recognized, the price-volume challenges we are experiencing today were not anticipated in the business model that was designed in 1970. The premise of that model with its letter mail monopoly was that moderate volume growth and postage rate increases at or below the economy's rate of inflation would finance universal service and the ever-expanding delivery network. However, since 1998, the volume of single piece First-Class letters has declined by 10.9 billion, or 20 percent, severely stressing the business model.

Our service to customers, our financial results, and continued improvements in our workplace environment and safety efforts were all outstanding in 2005. These achievements are amply described in this report. Some further reflection on the year, however, may provide insight useful to understanding future challenges.

Robust growth in the first quarter (October—December 2004) provided a jump start to revenue for the year as election mailings boosted Standard Mail volume and mailings by financial institutions increased First-Class Mail volume. Across all operations, our employees absorbed the surge in volume of almost 3 billion additional pieces, producing a high gain in total factor productivity. With volume then growing more than twice as fast as the growth in delivery addresses, we captured economies in our delivery network. In the remaining three quarters, volume growth was less than half of the first quarter rate and was not conducive to similar productivity gains.

An encouraging development was the slight growth in the year's total First-Class Mail volume after three years of volume decline. The decline of 1.8 billion single-piece-rate envelopes (37 cents) was offset by growth of 1.7 billion workshare-rate pieces. Total revenue for First-Class Mail did decline $300 million due to the mix change. As had been forecasted, Standard Mail volume grew 5.4 billion pieces, to 100.9 billion to exceed total First-Class Mail volume for the first time. Standard Mail volumes are becoming more volatile with time, affected as they are by economic conditions, the comparative price points of Standard Mail, and rapidly evolving alternative media.

Historically, First-Class Mail with its high volumes and higher dollar contribution over variable costs has financed the greatest part of the institutional costs of our nationwide Post Office and delivery network. As electronic diversion of First-Class Mail continues, Standard Mail's share in the mail mix will grow. Under the current business model, this alteration in the mail mix will result in postal revenues not keeping pace with ongoing inflation in costs and will intensify both our revenue volatility and postal vulnerability to business cycles.

As is widely recognized, the price-volume challenges we are experiencing today were not anticipated in the business model that was designed in 1970. The premise of that model with its letter mail monopoly was that moderate volume growth and postage rate increases at or below the economy's rate of inflation would finance universal service and the ever-expanding delivery network. However, since 1998, the volume of single piece First-Class letters has declined by 10.9 billion, or 20 percent, severely stressing the business model. While 2005's volume set a new record of 212 billion pieces, the shifting mix of the mail has affected revenues substantially. At 2005 postage rates, the lower volume and the specific mail mix of 2000 would have generated $3.3 billion more revenue.

To overcome these long-term challenges and ensure that the Postal Service continues to meet its mandate to the American people, change is required. Specific legislative action is required to remove a financial hurdle that imposes unnecessary costs on postal ratepayers while providing no public benefit other than technically reducing the federal deficit. That obstacle is the escrow requirement of P.L. 108-18 that is responsible for the 2006 rate increase. If continued, it will threaten the financial stability of the nation's mail system with escalating annual escrow funding requirements.

Regarding expenses, compensation and benefits have always constituted a major portion of our operating expenses, but the ongoing growth in the benefit portion of these costs has escalated at a disproportionately greater rate than compensation costs. Retirement and health benefits costs for postal employees and retirees, most of which are legislatively mandated, now total nearly $14 billion, which is 20 percent of all Postal Service expense. Nonetheless, unlike many private sector companies and, in fact, unlike the federal government, the Postal Service has fully funded its pension obligations. The Postal Service also pays the major portion of the premiums for its retirees' health benefits program.

In 2005, for the sixth consecutive year, we offset a portion of our cost inflation with significant productivity gains. In fact, since 2000, our annual productivity gains have averaged almost six times more than those achieved annually from 1972 through 1999. It is critical to understand that these productivity gains, which reduce costs, are not automatic—they result from sound governance, solid management, engaged employees, and the effective use of technology.

As the mail mix and sources of postal revenue undergo fundamental change, we must be able to rely on more than employee dedication and sound management to assure the viability of universal service. The Postal Service requires a governance structure that not only assesses accountability from the Board of Governors and management but also provides them with the broader authority necessary to enhance services, set prices, and control the full range of postal costs.

Richard J. Strasser, Jr.
Chief Financial Officer and
Executive Vice President

Retirement and health benefits costs for postal employees and retirees, most of which are legislatively mandated, now total nearly $14 billion, which is 20 percent of all Postal Service expense. Nonetheless, unlike many private sector companies and, in fact, unlike the federal government, the Postal Service has fully funded its pension obligations.

Financial review
Part I

Item 1. Business
Financial Information about Segments

We operate in one segment throughout the United States and internationally.

Narrative Description of Business

Overview

The United States Postal Service (we) commenced operations on July 1, 1971 as an independent establishment of the executive branch of the United States government. 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." We fulfill this legal mandate to offer universal service at a fair price by offering a variety of classes of mail services without undue discrimination among our many customers. This means that within each class of mail our price does not unreasonably vary by customer for the levels of service we provide.

We serve individual and commercial customers throughout the nation. We 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 (PRC).

Our mailing services (products) are distributed through our more than 37,000 Post Offices, stations and branches, contract postal units, our website *usps.com*, and a large network of consignees. We deliver mail to more than 144 million city, rural, Post Office Box, and highway delivery points. We conduct our significant operations primarily in the domestic market, with international operations representing less than 3% of our total revenue.

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union, and National Rural Letter Carriers Association. Approximately 90% 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. These consultations provide an opportunity to participate directly in the planning, development, and implementation of programs and policies affecting non-bargaining employees in the field. The management organizations include the National Association of Postal Supervisors, the National League of Postmasters, and the National Association of Postmasters of the United States. We participate in federal employee benefit programs as required by statute, for retirement, and workers' compensation.

Although we are not subject to regulation by the Securities and Exchange Commission (SEC), we comply voluntarily with the financial reporting requirements of the SEC to the extent that these requirements may be reasonably applied to a non-publicly traded, government-owned entity with a mandate to break even over time. Therefore, this report excludes certain SEC reporting elements normally included in a Form 10-K. Specifically, we have excluded: Item 4, Submission of Matters to a Vote of Security Holders; Item 5, Market for Registrant's Common Equity and Related Stockholder Matters; and Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Strategy

Since publication of our *2002 Transformation Plan*, we have delivered on our promise of focus and results.

Our new *Strategic Transformation Plan 2006-2010* builds on the foundation of the earlier plan and continues its momentum. In 2002 we were emerging from the multiple shocks of an economic slowdown, September 11, and the anthrax attacks. Mail volume fell, and America's confidence in the mail was undermined. The *2002 Transformation Plan* became our roadmap to recovery. It re-instilled confidence among our employees and set challenging but achievable targets in service and cost management. Productivity growth has been steady and strong. We have reduced complement by more than 80,000 through attrition and have realized cumulative savings of more than $15 billion through the end of 2005. Better service and stable rates have attracted new business. Advertising mail volume is up 10% in two years. To date, increases in advertising mail revenue have offset losses caused by competitive, technological changes that are moving communications, bills and payments online.

In our *Strategic Transformation Plan 2006-2010*, we commit to making further advances in service, productivity, and employee engagement. We will maintain a tight focus on our core products to ensure that universal, affordable postal services continue to have the power to promote communication, reach key audiences, and help bind America together. We are committed to continue taking $1 billion out of our cost base each year through 2010 while employing equally aggressive measures to grow the business.

For our customers, value is defined by quality of service, price, and ease of use. Over the next five years we will continue to improve the value of our products to promote growth. We will add new features to First-Class Mail to make it a more powerful communication tool for advertisers and financial service providers. Small businesses remain an enormous engine of the nation's commerce, and we are developing ways to make advertising mail more accessible and easier for them to use. In the advertising market our focus will be to offer services that help our customers' businesses grow. Customers will see continued improvements in package delivery services as we continue to automate operations, increase ease of use, and expand track and trace capabilities. These changes will better serve households and small businesses that use end-to-end package services. Improvements will also benefit consolidators who rely on us for delivery only. We earn 85% of our revenue from businesses and institutions, all of whom have choices in how they communicate, bill, and ship. To meet the needs of large business customers, we will develop integration strategies to tailor pricing to take advantage of the benefits of customer preparations, packaging and drop-shipping capability utilizing our network where possible.

Customers are finding that our services are more convenient. Services are available via *usps.com*, 1-800-ASK-USPS, by mail, self-service kiosks, grocery stores, ATMs and through new expanded business hours at Post Offices in the evenings and on Saturdays. The Web is making it easier and faster to deposit commercial mailings, as transactions such as manifesting, postage payment, and entry scheduling move from paper to electronic media.

Each day we receive and deliver almost 700 million pieces of mail. Distribution and transportation of these letters, parcels, catalogs, and magazines occur across a network of more than 37,000 Post Offices and retail outlets and 675 mail processing facilities. The mail is securely and reliably delivered to more than 144 million addresses. Over the past four years, we have improved our operations to produce better, more consistent service with fewer resources. Today, we deliver fifty percent more mail than we did two decades ago, with the same number of employees.

In the next five years, there will be more change. Delivery has become our largest cost center and will be the focus of intensive efficiency efforts. We will streamline the entire mail flow, to make it more flexible and responsive to the changing needs of our business. In the longer term, we will create a standardized network that contains fewer types of processing facilities. Larger regional distribution centers will serve as primary nodes for multiple products, and smaller local processing facilities will process all mail with destinations in their geographic areas. These changes will reduce costs and improve reliability.

We will continue to implement industry best practices throughout the mail value chain to eliminate costly rework and standardize operations resulting in benefits for both us and our customers. We, and the mailing industry, must work together to raise quality levels by assuring correct and complete addresses and routing information. As we streamline our networks and deploy new automated processing equipment, new tools will help us handle fluctuations in demand at the lowest possible cost. Tracking systems will show how mail flows across operations and advance notification systems will report how much mail is arriving. Planning models will calculate required resources.

We will hold ourselves accountable to our customers to deliver more consistent quality and higher levels of customer service. The higher the quality of service targeted, the greater the importance of identifying and maintaining a skilled and committed workforce. Our goal is an environment that encourages employees to strive to be the best. Therefore, we will continue to build a performance-based culture and improve the skill sets of our workforce at all levels. In our training and leadership development we will emphasize teamwork and customer focus. Our employees are known for a deep commitment to service, which is witnessed daily in the thousands of communities they serve. Building on this commitment, we will increase employee involvement at all levels and will continue to recognize high performers. Employees will have the opportunity to move up in the ranks of the organization through outstanding performance and career development opportunities.

We exceeded most of the aggressive targets that we set in our first phase of Transformation. In the course of executing that Plan, our employees gained new levels of confidence in the organization's ability to meet challenges. Despite the challenges ahead and the unresolved status of pending postal reform legislation, we are confident that we will also achieve the goals we have set for ourselves in this next phase of Transformation.

Services (Products)

The Postal Service is the centerpiece of the U.S. mailing industry. We provide a wide variety of services and products to meet almost any mailing need. Some of our major services and products are:

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First-Class Mail – Postcards, letters, or any mailable item, including advertisements and merchandise up to 13 ounces, can be sent using First-Class Mail. This service (or Express Mail or Priority Mail) is required for personal correspondence, handwritten or typewritten letters, and bills or statements of account.

Priority Mail – This 1-3-day delivery, non-guaranteed service is typically used to send documents, gifts, and merchandise.

Express Mail – This money-back guaranteed overnight or two-day service includes tracking, proof of delivery, and insurance up to $100. Delivery to most destinations is available 365 days a year with no extra charge for Saturday, Sunday, or holiday delivery.

Periodicals – Typical periodicals are newspapers, magazines, and newsletters. This service requires prior authorization by the Postal Service.

Standard Mail – Any mailable item, including advertisements and merchandise weighing less than 16 ounces, not required to be sent using First-Class Mail can be sent using Standard Mail. Standard Mail is typically used for advertisements and flyers. Additional content restrictions must be met for authorized nonprofit mailers.

Package Services – Includes Parcel Post, Bound Printed Matter, Library Mail and Media Mail up to 70 pounds.

Special Services – In addition to these and other classes of mail, we offer a variety of enhancements that add value to mail by providing additional security, proof of delivery, or loss recovery. These product enhancements include: Certified Mail, Registered Mail, Delivery Confirmation, Signature Confirmation and insurance.

Money Orders – Are offered as a safe, convenient, and economical alternative to sending cash through the mail. They can be purchased from any Post Office in the United States as well as from any rural route carrier. Postal Money Orders are available up to $1,000 with a daily purchase limit of $10,000 per customer. Money orders can be cashed at any Post Office or can be deposited or negotiated at financial institutions. Money orders are replaced if damaged, lost, or stolen.

Rate and Classification Activity

The 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. 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 April 8, we filed a request to increase most rates and fees by 5.4% to generate $3.1 billion annually. Some exceptions have been proposed to ensure that rates or fees cover costs or to meet statutory requirements. The case is Postal Rate and Fee Changes Pursuant to Public Law 108-18, PRC Docket No. R2005-1. Revenues requested in this filing will partially fund the 2006, $3.1 billion escrow requirement established by Public Law 108-18. Were it not for this escrow requirement, we would not have filed this rate increase request.

On November 1, 2005 the PRC issued its Decision on Docket No. R2005-1 to the Board of Governors. The Commission determined that the across-the-board increase suggested by the Postal Service will generate necessary revenues and is consistent with the public policies established by the Postal Reorganization Act. On November 14, 2005 the Governors voted to accept the Postal Rate Commission's recommendations to take effect January 8, 2006.

Information on PRC recommended decisions and pending dockets can be obtained at the PRC web site *http://www.prc.gov.*

Competition

The Internet continues to dramatically change the communications market. Within the next decade further innovations such as mobile commerce, broadband, interactive TV, data mining software, and new printing technologies will change the way businesses and consumers interact. While hard copy mail retains tremendous effectiveness, there is little doubt that its share of the overall communications market will continue to shrink.

Of greatest impact on us are electronic alternatives to correspondence and transactions, particularly for First-Class Mail items such as business correspondence/forms, bills, statements, and payments. First-Class Mail volumes have already been affected by the telephone, fax machine, Internet, and other electronic communications. The Internet is also forcing us into greater competition with the private sector. The Internet and electronic commerce are stimulating utilization of other postal products, such as package delivery and targeted ad mail. These products are subject to competition from traditional sources (e.g., newspaper and TV ads and other package delivery firms).

Major corporations now dominate parcel and express markets. Under the current regulatory structure, competitors have far more flexibility to respond to changes in market conditions and to target specific customers than we do.

The competitive landscape for postal services is becoming much more global. Foreign postal operators are moving well beyond traditional postal services, offering logistics, financial services, and electronic services. Several European posts have set-up operations in 18 major metropolitan areas nationwide. These operations feature some sales offices and offer mail, parcel, logistics, and financial services to the American market. A significant portion of foreign outbound letters are carried by foreign posts, due to our higher rates, which are driven by our unfavorable international air transportation costs.

Intellectual Property

We own valuable intellectual property including trademarks, service marks, patents, copyrights, trade secrets and other proprietary information. We routinely generate intellectual property in the course of developing and improving our systems, products, and operations.

Seasonal Operations

Our operations are seasonal. Mail volume and revenue tends to be greatest in our first fiscal quarter, the fall mailing season, and lowest during the summer, our fourth quarter.

Working Capital Practices

Information about our working capital practices is included in Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7, page 29, and the Statement of Cash Flows for the years ended September 30, 2005, 2004 and 2003 on page 45.

Customers

We have a very diverse customer base and we are not dependent upon a single customer or small group of customers.

Government Contracts

No material portion of our business is subject to renegotiation of profits or termination of contracts or subcontracts at the election of the U.S. government.

Research and Development

We operate a research and development facility in Virginia. While research and development activities are important to our business, these expenditures are not material. We also contract with independent suppliers to conduct research activities that benefit us.

Environmental Matters

We are not aware of any federal, state or local environmental laws or regulations that will materially affect our financial results or competitive position or result in material capital expenditures. However, we cannot predict the effect on our operations of possible future environmental legislation or regulations.

In response to the continuing threat of biological terrorism, utilizing the mail as the delivery medium, the Board of Governors approved the Biohazard Detection System and the Ventilation Filtration System projects. These projects, which are in the process of being deployed, will provide a level of protection to our employees and customers from potential contamination.

Number of Employees

At year-end, we had 704,716 career employees, substantially all of whom reside in the United States. We also had 98,284 non-career employees. See Operating Statistics on page 56 for additional detail.

Available Information

The United States Postal Service is not subject to the informational requirements of the Securities Exchange Act of 1934 (Exchange Act). We do not file periodic reports, proxy statements or other information with the SEC.

Financial and other information can be accessed on the "About USPS and News" section of our website at *usps.com.* We make available, free of charge, copies of our annual report, as soon as reasonably practicable after it is produced. Copies of financial and other information are

available free of charge by sending a request to:
United States Postal Service
Public Affairs and Communications,
475 L'Enfant Plaza, SW,
Washington, DC 20260-5241.

Information on our website is not incorporated by reference in this document.

Item 2. Properties

We currently control more than 34,000 leased or owned facilities in the United States, its possessions, and territories. We also contract with approximately 3,000 locations to distribute our products. The size of our facilities ranges from fifty square feet to as large as 35.3 acres under one roof. The types of real estate include, but are not limited to, Post Offices, carrier facilities, mail processing plants, retail outlets, business office space, warehouse space, vehicle maintenance facilities, and other permanent or temporary space. The vast majority of these facilities are Post Offices, stations, branches, and carrier annexes. We have 675 processing and distribution facilities (Processing and Distribution Facilities, Air Mail Facilities and Bulk Mail Facilities), and over 1,000 other types of facilities including administrative, support and vehicle maintenance facilities.

(Dollars in millions)

Real estate inventory	2005	2004
Leased facilities	25,772	25,413
Owned facilities	8,399	8,807
GSA/other government facilities	417	425
Annual rent paid to lessors	$ 934	$ 946

Processing Facilities	2005	2004
Processing and distribution centers	269	269
Customer service facilities	195	195
Bulk mail processing facilities	21	21
Priority mail processing centers	11	11
Annexes	66	66
Hub and spoke processing facilities	14	14
Air mail processing centers	79	79
Remote encoding centers	15	15
International service centers	5	5
Total Processing Facilities	**675**	**675**

We have one of the largest vehicle fleets in the country, including an extensive fleet of alternative fuel vehicles.

Vehicle inventory	2005	2004
Delivery & Collection Vehicles (1/2 – 2 ton)	188,673	188,804
Mail Transport Vehicles (3 – 9 ton)	3,050	2,580
Mail Transport Vehicles (Tractors and Trailers)	6,909	7,105
Service Vehicles	5,688	5,468
Administrative Vehicles and Other Vehicles	6,533	6,603
Inspection Service and Law Enforcement Vehicles	3,293	2,761
Total Owned Vehicles	**214,146**	**213,321**

Item 3. Legal Proceedings

We are subject to various claims and liabilities that arise in the ordinary and normal course of postal operations. These claims generally cover labor, tort, and contract disputes and are regularly reviewed by management and, where significant, by the Audit and Finance Committee of the Board of Governors, or the full Board of Governors. In our evaluation, no single claim is material to our financial statements taken as a whole. We have accrued in our financial statements of September 30, 2005, the estimated impact of those claims we think it is probable we will pay. Further details on these claims are identified in Note 10 of the Notes to the Financial Statements

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

Not applicable to this report.

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Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Not applicable to this report.

Item 6. Selected Financial Information

See Financial History Summary on pages 58–59.

Cautionary Statements

Our discussion in the Management Discussion and Analysis represents our best estimate of the trends we know about, the trends we anticipate, and the trends we think are relevant to future operations. However, actual results may be different from our estimates. Certain forward-looking statements are included in this report. They use such words as "may," "will," "expect," "believe," "plan," and other similar terminology. These statements reflect our current expectations regarding future events and operating performance and speak only as of the date of this report. These forward-looking statements involve a number of risks and uncertainties.

The following are some of the factors that could cause actual results to differ materially from those expressed in, or underlying, our forward-looking statements: effectiveness of operating initiatives; success in advertising and promotional efforts; changes in national and local business and economic conditions, including their impact on consumer and business confidence; fluctuations in currency exchange and interest rates; labor and other operating costs; oil, fuel and other transportation costs; the effects of war and terrorist activities; competition, including pricing and marketing initiatives and new product offerings by our competitors; consumer preferences or perceptions concerning our product offerings; spending patterns and demographic trends; availability of qualified personnel; severe weather conditions; effects of legal claims; cost and deployment of capital; changes in laws and regulations; and changes in applicable accounting policies and practices. The foregoing list of important factors is not all-inclusive.

We have no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Volume and Revenue

Revenue for 2005 was $69,993 million, an increase of $964 million over last year. This increase was primarily due to Standard Mail which accounted for $831 million dollars of the increase. Total volume in 2005 of 211,743 billion pieces was 5.6 billion pieces above last year, primarily due to an increase of 5.4 billion additional pieces of Standard Mail. More than half of the growth in 2005 volume and revenue came in Quarter 1. A number of factors aligned to generate strong revenue and volume growth in Quarter 1, including solid U.S. economic growth, strengthening direct marketing channels, the quadrennial impact of election mailings and increased marketing activity in financial services and credit cards. A calendar shift that added two days to the holiday marketing and mailing season between Thanksgiving and Christmas also contributed to the strong first quarter results.

In 2005 Standard Mail volume exceeded First-Class Mail volume for the first time. Continued strong growth in retail sales, and a favorable investment environment led to increases in advertising spending, which spurred the growth in Standard Mail volume and revenue. Standard Mail volume growth was aided considerably by November 2004 election mail as well as being driven by the increasing strength of direct marketing channels and surges in credit card marketing. Standard Mail has also benefited from the "Do Not Call" telephone restrictions. Standard Mail continues to hold its ground in the advertising market

(Pieces in millions)				% Change	
Volume	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
First-Class Mail	98,071	97,926	99,059	0.1%	-1.1%
Priority Mail	887	849	860	4.6%	-1.3%
Express Mail	55	54	56	2.5%	-3.6%
Periodicals	9,070	9,135	9,320	-0.7%	-2.0%
Standard Mail	100,942	95,564	90,492	5.6%	5.6%
Package Services	1,166	1,132	1,129	2.9%	0.3%
International	852	844	805	0.9%	4.8%
Other*	700	602	464	16.2%	29.7%
Total	**211,743**	**206,106**	**202,185**	**2.7%**	**1.9%**

Note: Percentages are calculated based on unrounded numbers.
* Postal Service volume, mailgrams and free matter for the blind are included in the "Other" category.

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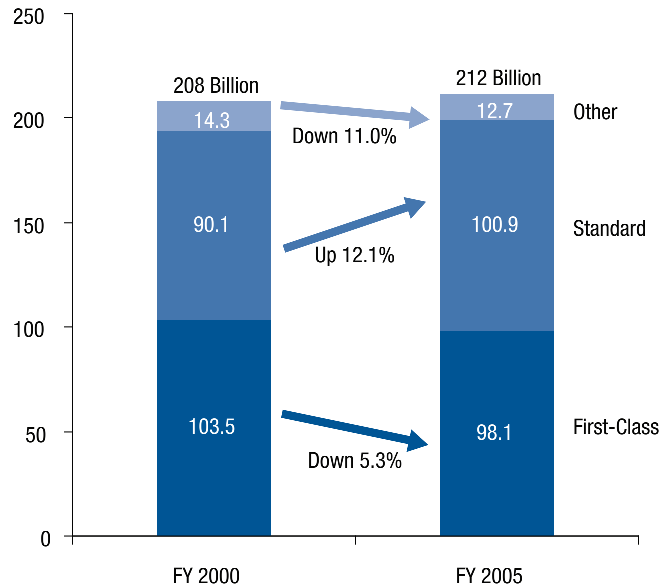
MAIL MIX COMPARISON
(Pieces in billions)



by virtue of its two dominant characteristics: it can be targeted to specific audiences, and its effectiveness can be measured.

First-Class Mail volume, which was our largest mail class until 2004, increased slightly in 2005 after declining for three consecutive years. The increase in workshare First-Class Mail pieces (up 1.8 billion pieces or 3.7%) offset the continuing decline in single-piece volume (down 1.8 billion pieces or 4.0%). The long-term continued decline in single piece volume reflects the impact of electronic diversion as businesses, nonprofit organizations, governments, and households increasingly automate all transactions and divert correspondence to the Internet. The consolidation in the pre-bar-coded mailer market and anecdotal evidence suggests that some of the single piece First-Class Mail may be migrating to workshare First-Class Mail. Following several years of essentially no change in workshare First-Class Mail volume, volume grew in 2005, driven by the advertising and financial markets.

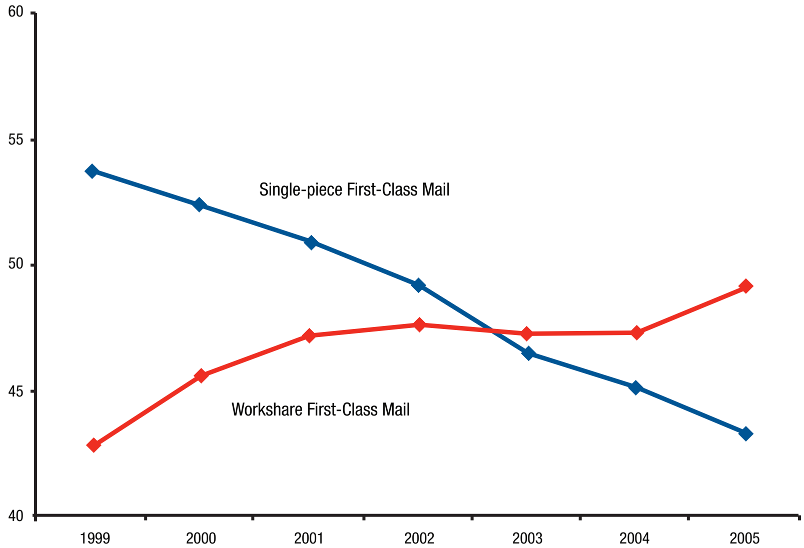
After declining for four consecutive years, Priority Mail volumes increased. Four factors underlie this performance. First, Priority Mail rates have stayed steady for three years while competitors' published rates have increased annually. Second, the proliferation of competitors' surcharges for fuel, residential delivery, and delivery in rural areas make Priority Mail increasingly attractive, especially for small-volume users, who generally cannot negotiate discounts or other pricing concessions with private sector competitors. Third, Priority Mail is easier to use than ever. Customers can purchase postage and print mailing labels with free delivery confirmation on-line through Click-N-Ship or on websites such as eBay. The Carrier Pickup online notification program saves customers a trip to the Post Office. Letter carriers averaged 4,000 daily pickups in 2005. Also contributing to growth in Priority Mail is the Priority Flat Rate Box. Launched in November 2004, revenues from this service are growing strongly. Through this service, customers can send packages via Priority Mail at a flat rate of $7.70. Two differently shaped boxes are available to customers, both with the same cubic capacity. Finally, we have worked to consistently improve Priority Mail service performance. Express Mail and Package Services have experienced similar turnarounds for many of the same reasons. Periodical Mail volume and revenue are declining, as businesses and consumers increasingly rely on the Internet as a substitute for hardcopy publication of news, information, and entertainment.

(Dollars in millions)

				% Change	
Revenue	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
First-Class Mail	$ 36,062	$ 36,377	$ 37,048	-0.9%	-1.8%
Priority Mail	4,634	4,421	4,494	4.8%	-1.6%
Express Mail	872	853	888	2.3%	-3.9%
Periodicals	2,161	2,192	2,235	-1.4%	-1.9%
Standard Mail	18,953	18,123	17,231	4.6%	5.2%
Package Services	2,201	2,207	2,216	-0.3%	-0.4%
International	1,765	1,696	1,587	4.1%	6.9%
Other*	3,345	3,160	3,065	5.9%	3.1%
Total	**$ 69,993**	**$ 69,029**	**$ 68,764**	**1.4%**	**0.4%**

Note: Percentages are calculated based on unrounded numbers.
*Mailgrams are included in the "Other" category as are special service revenues, other income and investment income.

FIRST-CLASS MAIL VOLUME
(Pieces in billions)



Operating Expenses

Operating Expenses are comprised of Compensation and Benefits, Transportation, Supplies and Services, Depreciation and Amortization and Other Expenses and are discussed in the sections to follow.

In 2005 Operating expenses of $68,283 million were $2,432 million more than 2004. The increase was driven primarily by increases in compensation and benefits and transportation expenses. Rising fuel prices contributed significantly to the increase in transportation expenses, and also contributed to increased compensation and benefits expenses through their impact on employee cost-of-living adjustments (COLAs). Compensation and benefits expense growth was also influenced heavily by contractual pay increases, and retirement and health benefits costs. These same factors, in somewhat different proportions also drove the $1,949 million increase in operating expenses in 2004, compared to 2003.

Compensation and Benefits

Personnel compensation and benefits, including interest on deferred retirement obligations, made up 79.1% of our total expenses. These costs grew $1,958 million in 2005. This year's growth was due primarily to contractual labor rate increases, COLAs, health benefits payments for current and retired employees and an increase in interest on deferred retirement. Our 2005 average hourly labor rates increased by 2.5%, and our 2005 health benefits expense for current employees and retirees increased by $437 million to nearly $6.6 billion, or 9.7% of total

(Dollars in millions)

				% Change	
Operating Expenses	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
Compensation and Benefits*	$ 53,932	$ 52,134	$ 50,428	3.4%	3.4%
Transportation	5,437	4,969	4,989	9.4%	-0.4%
Supplies and Services	2,416	2,414	2,328	0.1%	3.7%
Depreciation and Amortization	2,089	2,145	2,295	-2.6%	-6.5%
Other expenses	4,409	4,189	3,862	5.3%	8.5%
Total Operating Expense	**$ 68,283**	**$ 65,851**	**$ 63,902**	**3.7%**	**3.0%**

*This does not include interest on deferred retirement obligations, which is included on the compensation and benefits table below. Interest is not considered an operating expense on the financial statements.

(Dollars in millions)

				% Change	
Compensation And Benefits	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
Compensation	$ 39,299	$ 37,876	$ 37,144	3.8%	2.0%
Retirement	7,073	6,574	5,877	7.6%	11.9%
Health Benefits	5,100	4,845	4,526	5.3%	7.0%
Retiree Health Benefits	1,495	1,313	1,133	13.9%	15.9%
Workers' Compensation	838	1,239	1,473	-32.4%	-15.9%
Other	390	390	391	0.0%	-0.3%
Total Compensation and Benefits*	**$ 54,195**	**$ 52,237**	**$ 50,544**	**3.7%**	**3.3%**

* Equals compensation and benefits plus interest on deferred retirement on the financial statements.

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(In thousands)				% Change	
Workhours	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
Operations					
Operations Support	9,606	9,077	9,102	5.8%	-0.3%
Mail Processing	336,210	336,737	347,964	-0.2%	-3.2%
Rural Delivery	179,549	171,628	166,873	4.6%	2.8%
City Delivery	471,071	464,683	464,300	1.4%	0.1%
Vehicle Services	31,880	31,947	32,111	-0.2%	-0.5%
Limited Duty and Rehabilitation	3,604	6,356	21,455	-43.3%	-70.4%
Plant & Equipment Maintenance	80,867	81,302	81,807	-0.5%	-0.6%
Customer Services & Retail	233,953	233,237	232,529	0.3%	0.3%
Postmasters & Installation Heads, Supervisors, Administration and Other	116,513	117,354	117,652	-0.7%	-0.3%
Total Workhours	**1,463,253**	**1,452,321**	**1,473,793**	**0.8%**	**-1.5%**

expenses. The increase in these expense categories was partially offset by a $401 million decrease in workers' compensation expense (see workers' compensation discussion on page 26).

In addition to labor and benefits rates, workhours are the other major component of our compensation and benefits expense. This year's growth in costs was driven by an increase of almost 11 million workhours, the first time in six years in which workhours increased over the prior year. The workhour increase involved increased workload due to the addition of 2 million delivery points and an additional 6 billion pieces of mail. Despite the slight increase in 2005, we have cumulatively eliminated 686 million workhours since 2000. This has been the single biggest contributor to the ongoing achievement of our Transformation Plan savings targets.

The 2004 increase of $1,693 million in compensation and benefits expenses was driven by the same factors as the 2005 increase, although COLAs were smaller in 2004. Average hourly labor rates in 2004 increased by 1.7% over 2003. The increase in compensation and benefits in 2004 was somewhat alleviated by a $234 million decrease in workers compensation expenses and a 21 million workhour reduction. Beginning in 2004, we implemented a change in how we track workhours for employees in limited duty or rehabilitation assignments. The workhours for these employees are now included in the functions (operations) in which they work.

Almost 90% of our career workforce is covered by collective bargaining agreements. Our major collective bargaining agreements all have an expiration date of November 20, 2006, and currently require annual basic pay increases and semi-annual COLAs.

Our non-bargaining employees receive pay increases only through a pay-for-performance program that makes meaningful distinctions in performance. These employees do not receive automatic salary increases, nor do they receive COLAs or locality pay.

Retirement Expense

With certain exceptions, our employees participate in one of three retirement programs based on the starting date of their employment with the Federal Government. These programs are the Civil Service Retirement System (CSRS), the Dual CSRS/Social Security System (Dual CSRS), and the Federal Employees Retirement System (FERS). Each of these programs is described in further detail in Note 6 of the Notes to the Financial Statements. 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.

In 2005, OPM increased the contribution percentage employers pay for FERS participants, from 10.7% to 11.2%. This increase added over $100 million to our retirement expense in 2005.

The implementation of P.L.108-18 (discussed in detail below) in May 2003 did not alter the fact that retirement expenses remain a significant portion of our total expenses. Retirement contributions for current employees represented 10.3% of our total expenses in 2005, 10% in 2004, and 9.1% in 2003. In 2003 we benefited from a one-time reduction in our retirement expenses resulting from the enactment of P.L.108-18.

As described in Note 6 of the Notes to the Financial Statements, we account for our involvement in these retirement programs as a participant in a multi-employer plan. However, OPM does maintain postal specific records that identify the present value of benefits, the present value of contributions and the value of the postal fund. The following table provides this information for the CSRS and FERS programs as of September 30, 2004, the most recent data provided by OPM.

(Dollars in billions)

Program	Present Value Of Benefits	Present Value Of Expected Future Employer & Employee Contributions	Current Postal Fund	Surplus (Deficit)
CSRS	$ 195.0 B	$ 14.1 B	$ 176.7 B	$ (4.2) B
FERS	71.3 B	33.1 B	47.7 B	9.5 B
Total	**$ 266.3 B**	**$ 47.2 B**	**$ 224.4 B**	**$ 5.3 B**

Public Law 108-18 (P.L.108-18)

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 Civil Service Retirement and Disability Fund (CSRDF). P.L.108-18 was enacted in response to a November 2002 review of estimates and the Postal Service's payments into and returns earned by the CSRDF. OPM determined that at the end of 2002, we had funded more than would be needed to cover the future benefits expected to be paid to our employees and retirees participating in CSRS under then current law.

P.L.108-18 required us, in May 2003, to begin to fund our obligations to the CSRDF based on dynamic assumptions. P.L.108-18 requires that the dynamic funding assumptions include the full value of future benefits related to military or volunteer service when calculating the actuarial present value of future benefits by OPM. Under the previous existing law, military and voluntary service costs were funded by the United States Treasury Department. The recognition of military service credit effectively transferred $27 billion in obligations from U.S. taxpayers to our ratepayers. This change in funding responsibility changed our CSRS funding status at the end of 2002 from being over funded to being under funded. Use of dynamic assumptions for the valuation also increased our biweekly payroll contribution for CSRS employees' retirement from 7.0% of basic pay to 17.4%.

In addition to the 17.4% employer contribution, we make annual payments on the excess of the actuarial present value of future benefits over the actuarial present value of plan assets, future plan contributions, earnings, and other factors. This amount is referred to as the "supplemental liability" and is calculated by OPM each year. In September 2004, OPM informed us that our first supplemental payment, based on the September 30, 2003 valuation, would be $240 million. We included $125 million of this payment in our 2003 expenses and $115 million in 2004. In 2005 the "supplemental liability" payment increased to $290 million based on OPM's valuation of the "supplemental liability" at $4.2 billion as of September 30, 2004. See note 7 of the Notes to the Financial Statements for further explanation.

Use of P.L.108-18 "Savings"

P.L.108-18 identifies as "savings" the difference between the contributions we would have made to the CSRDF had the legislation not been enacted, and the contributions we now make under the law. In 2003 and 2004 we were required to use these "savings" to reduce our debt. In 2003, OPM calculated our "savings" to be $3.5 billion, and we reduced our debt with the U.S. Treasury by $3.8 billion, thus exceeding the requirements of the law. In 2004, we used "savings" of $2.7 billion to reduce our outstanding debt to the U.S. Treasury. In addition to the required debt reduction we also reduced our debt by an additional $2.8 billion, for a total debt reduction of $5.5 billion in 2004. In 2005 we paid our remaining debt of $1.8 billion, and used the remainder of the "savings" to offset operational expenses and hold postage rates steady.

As required by P.L.108-18, on September 30, 2003, we submitted two proposals to the President, Congress, and the Government Accountability Office. The first presented our position as to how the "savings" realized after 2005 should be used; the second presented our position that the obligation to pay CSRS liabilities arising from military service be returned to the U.S. Treasury. In both proposals, we recommended eliminating the escrow requirement and proposed using a portion of the "savings" after 2005 to help finance federal retiree health benefit obligations. As discussed in the "Pending Legislation" section, two pieces of legislation addressing, among other issues, the funding of CSRS credit for military service and the escrow provisions of P.L.108-18 are currently pending before Congress.

Congress will consider what to do with the post-2005 "savings" but until Congress acts, any "savings" after 2005 must be placed in escrow. To fund the 2006 escrow requirement, in April 2005, the Board of Governors approved a request to the PRC for a recommended decision for an across-the-board increase in postage rates and fees of 5.4%. On November 14, 2005 the Governors voted to accept the Postal Rate Commission's recommendations to increase most postal rates and fees by approximately 5.4% across-the-board to take effect January 8, 2006.

Health Benefits

We participate in the Federal Employees Health Benefits Program (FEHBP) which is administered by OPM. Eligible postal employees with at least five consecutive years participation in the FEHBP immediately preceding retirement are entitled to continue FEHBP coverage into retirement. We account for employee and retiree health benefit costs as an expense in the period our contribution is due and payable to the FEHBP.

The drivers of our active employee health care costs are the number of employees electing coverage and the premium costs of the plans they select. Premiums for each plan participating in FEHBP are determined annually by OPM. In 2005, health benefits expenses for active employees were $5,100 million, an increase of $255 million over 2004. This was 7.4% of our total expenses. The 2004 expense of $4,845 million was 7.3% of our total expenses and increased by $319 million over 2003 when employee health benefits were 7.0% of our expenses.

Retiree health benefits costs of $1,495 million in 2005 represent 2.2% of our total expenses, up from $1,313 million or 2.0% in 2004 and $1,133 million or 1.8% in 2003. This cost has risen steadily over the last two years, and has doubled since 2000, driven by increases in FEHBP premium costs, an increasing number of annuitants enrolled in the plan, and the declining number of annuitants for whom a portion of the premium cost is allocable to Post Office Department service. The combined effects of these drivers increased retiree health benefit costs by 13.9% or $182 million in 2005 and 15.9% or $180 million in 2004.

OPM recently announced a 6.6% average increase in health benefit premiums, to take effect in January 2006, following a 7.9% increase in January 2005. This is the lowest increase in average premiums in nine years and represents a very encouraging development. However, the pool of covered annuitants will continue to grow rapidly in the future, resulting in double-digit percentage increases of this expense. As of the end of 2005, there were approximately 444,000 Postal Service annuitants and survivors compared to 438,000 in 2004. We estimate that over 200,000 of our current employees will be eligible for retirement by 2008.

As an independent establishment of the U.S. government, our participation in FEHBP is considered as a participant in a multi-employer plan. If we were not considered a participant of a multi-employer plan, we would be required to record and disclose our obligation for future costs under the program. Because there are several areas of judgment involved in calculating this obligation, estimates can vary widely based on the assumptions used. Based on September 30, 2005 data, we estimated the 2005 present value of future premium payments to be between $50 billion and $59 billion. Based on September 30, 2004 data, we estimated the 2004 value of future payments to be between $48 billion and $59 billion. In both cases, the range in the estimate exists only because long-term medical inflation assumptions differed by 1%.

In December 2003, President Bush signed into law the Medicare Prescription Drug Modernization Act of 2003 (P.L.108-173). This Act will add a voluntary prescription drug benefit to the Medicare program that could have a significant impact on future Postal Service health care costs.

Under the terms of the P.L.108-173, employers, including the federal government, are eligible to receive the Medicare employer prescription drug subsidy if their benefit plans provide prescription drug coverage at or above specified levels. We qualify for this subsidy through our direct payment of the employer's premium to the FEHBP that is administered by OPM. Therefore, we have applied as a Medicare Part D provider which would enable us to receive the employer's retiree prescription drug subsidy.

OPM has said that it will forego the Medicare employer prescription drug subsidy for 2006 on the basis that there is no good rationale to pay itself to continue providing drug coverage to federal retirees of agencies that are fully supported by federal tax dollars. As distinct from the federal government, we directly fund the costs of our retirees' health benefits with revenues generated through postage rates, not taxpayer dollars. In fiscal year 2005, we paid $6.6 billion for employee and retiree health benefits and we estimate that approval as a Medicare Part D provider we could save postal ratepayers $250 million per 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) which makes all decisions regarding injured workers' eligibility for benefits. However, we pay all workers' compensation claims out of postal funds.

We record as a liability the present value of all future payments we expect to make to those employees receiving workers' compensation. At the end of 2005, we estimate our total liability for future workers' compensation costs at $7,521 million, a decrease of $58 million or 0.8 % from 2004.

In 2005 we experienced a 4.4% decrease in the number of paid medical claims and a 5.5% decrease in the number of paid compensation claims. These decreases led to a reduction of $12 million for paid claims when compared to 2004. Lower paid claims led to a $58 million dollar reduction of our total workers' compensation liability, which resulted in a decrease of our workers' compensation expenses of $401 million. This builds on decreases of $234 million in 2004 and $51 million in 2003. These lower costs are a result of our efforts to prevent workplace injuries and our joint initiative with OWCP to increase the number of injured employees returned to work. There have been a total of 570 successful outplacement/rehabs since the program inception three years ago. It has long term impacts to the cost of workers' compensation by reducing the base costs. The program is on pace to achieve the five year goal of 1,000 outplacements. Finally, OWCP has instituted a more rigorous review of medical bills to lower costs.

In 2004, we made changes to the discount rates we use to estimate our liability in order to improve the accuracy of our estimate. We discuss these changes in Note 3 of the Notes to the Financial Statements.

Transportation Expenses

Transportation expenses for 2005 were $5,437 million, an increase of $468 million over 2004 expenses. This increase was primarily due to increased fuel expenses of $214 million and an increase in mail volume. The increase in volume accounted for an additional $222 million in expense.

We continue to implement a number of measures to control fuel expenditures. These efforts focus on leveraging our size and buying power to obtain more favorable pricing by purchasing fuel in bulk. For example, we minimize our fuel cost for certain highway contract routes by consolidating our fuel purchases. We also purchase fuel in bulk through the Defense Energy Support Center wherever we have bulk facilities.

Air Transportation

Air transportation expenses for 2005 were $2,445 million, an increase of $260 million over 2004. This increase is primarily due to increased fuel charges as well as increased mail volume and contractual rate increases for our dedicated air transporter. During 2005, the index by which jet fuel costs are adjusted for our dedicated air carrier increased 50.1%, resulting in an increase in fuel costs of approximately $83 million. Increased mail volume added an additional $26 million in fuel costs.

(Dollars in millions)

Transportation Expenses	2005	2004	2003	% Change 2005-2004	% Change 2004-2003
Air Transportation	$ 2,445	$ 2,185	$ 2,253	11.9%	-3.0%
Highway Transportation	2,658	2,423	2,393	9.7%	1.3%
Other Transportation	334	361	343	-7.5%	5.2%
Total	**$ 5,437**	**$ 4,969**	**$ 4,989**	**9.4%**	**-0.4%**

Air transportation expenses decreased by $68 million in 2004, in spite of increased fuel charges as well as increased mail volume and contractual rate increases for our dedicated air transporter. We were able to offset these increases in two ways. During our peak holiday season, we significantly reduced the number of dedicated airplanes formerly used to move mail. This saved us approximately $54 million. We also moved more mail through the dedicated air network reducing charges from other commercial air carriers by $92 million. During 2004, the index by which jet fuel costs are adjusted for our dedicated air carrier increased 6.34%, resulting in an increase in fuel costs of approximately $10 million. Increased mail volume added an additional $7 million in fuel costs.

Highway Transportation

Highway transportation expenses increased by $235 million in 2005 as fuel prices and volumes increased. Diesel fuel used by our highway contract routes rose $102 million, while increased volumes and usage of highway transportation added another $137 million in expense over 2004 totals.

Highway transportation expenses increased by $30 million in 2004. This was primarily due to increasing prices for diesel fuel used by our highway contract routes which increased $31 million.

Other Transportation

Other transportation expenses decreased by $27 million in 2005 primarily as a result of our decision to reduce the

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use of rail to transport mail and shift this mail onto highway routes. This was done as a result of the higher service performance scores that our highway contractors were achieving. For 2004 Other transportation expenses increased $18 million. This was due to increases in international terminal dues of $21 million.

Aviation Security

On October 18, 2005, the President signed into law the 2006 Homeland Security Appropriations Act (P.L.109-90) which includes language directing the Department of Homeland Security (DHS) to triple the amount of cargo that is screened before being placed on commercial airlines, a requirement which had previously been included in the 2005 version of the appropriations bill. The law also requires DHS to strengthen the Transportation Security Administration's (TSA) known shipper program, which targets cargo from shippers unknown to the carrier. P.L.109-90 also directs TSA to utilize existing technology for checking passenger baggage for explosives to screen cargo "to the greatest extent practicable." The Postal Service will continue to monitor and communicate with TSA as it implements these legislative mandates.

Lawmakers continue to be concerned about cargo and aviation security. Additional legislation in the 109th Congress has been introduced to establish an air cargo security inspection program, which would be required to use equipment, technology, and personnel to inspect cargo that, at a minimum, meet the same standards established to inspect passenger baggage. This would require all cargo to be screened, a stricter requirement than P.L.109-90. Mail is considered air cargo for these purposes. Issues surrounding air cargo security legislation include the requiring of proper equipment for effective screening, and the increased time and expenses associated with cargo inspections.

(Dollars in millions)

				% Change	
Supplies and Services	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
	$2,416	$2,414	$2,328	0.1%	3.7%

Supplies and Services

Supplies and services expenses of $2,416 million remained relatively flat in 2005. In 2004, supplies and services expense charges of $2,414 million increased $86 million. The increase was primarily attributable to a $50 million increase in purchases of mail transportation equipment compared to 2003.

(Dollars in millions)

				% Change	
Depreciation and Amortization	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
	$2,089	$2,145	$2,295	-2.6%	-6.5%

Depreciation and Amortization

Depreciation and amortization expenses of $2,089 million in 2005 were $56 million less than last year. Depreciation expenses of $2,145 million in 2004 decreased $150 million from 2003. The depreciation decreases in both years were the result of lower capital spending in 2002 and 2003.

(Dollars in millions)

				% Change	
Other Expenses	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
	$4,409	$4,189	$3,862	5.3%	8.5%

Other Expenses

Other expenses of $4,409 million increased by $220 million in 2005, a reduction from the $327 million increase from 2004. The major components included in this category are rent and utilities of $1,589 million, vehicle maintenance services of $1,036 million, information technology of $398 million, facility maintenance services of $223 million and communications of $253 million.

Rent and utilities, up $29 million or 1.9%, experienced slower growth than 2004, when the increase was 6% or $85 million over 2003. Vehicle maintenance services increased by $114 million, or 12%, as the fleet ages and fuel costs rise, the same was true in 2004 when the increase was $63 million or 7% over 2003. Communications increased $35 million mainly from upgrading the communication lines in many offices. In 2004 communication was $13 million more than 2003. Information technology costs decreased $78 million, or 16% in 2005, this was on top of the $66 million decrease achieved in 2004. This reflects the continuing downward price trend in this industry and favorable negotiations on software maintenance and licensing agreements. Facility maintenance services declined $21 million as repair projects returned to a more normal level, in contrast to the $64 million increase in 2004. The 2004 increase was a result of long delayed repair projects that were undertaken. We also spent $55 million in 2004 to decontaminate the Trenton, NJ and Washington, DC facilities closed due to the Anthrax attack.

In 2005, we increased our provision for contingent liabilities due to an adverse settlement of three labor-related arbitration cases. These cases which are recorded as miscellaneous expenses contributed approximately $115 million to the increase in Other expenses in 2005. This was the opposite of 2004 when our contingent liability expense decreased $32 million from 2003. These swings are not unusual due to the unpredictable timing of these types of cases.

In 2005, we re-evaluated our allowance for bad debt methodology, based on our last five years of collection history. This change in estimate reduced our bad debt expense by $77 million over 2004. In 2004 bad debt expense increased $25 million over 2003.

Productivity

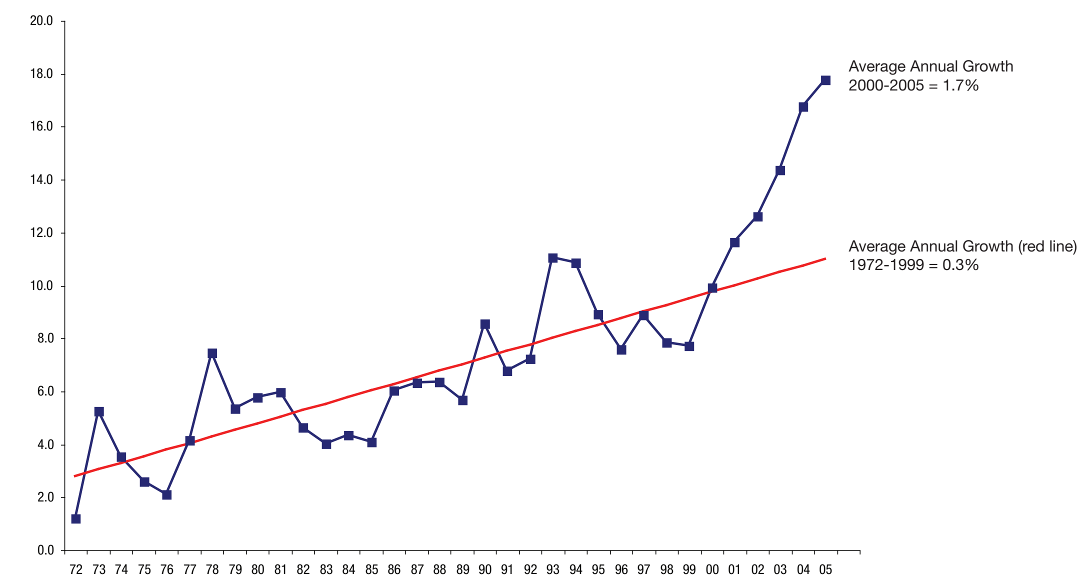
We use two indicators to measure our efficiency. We use output per workhour, which measures the change in the relationship between workload (mail volume and deliveries) and the labor resources used to do the work. We use total factor productivity (TFP) to measure the change in the relationship between outputs, or workload, and all the resources used in producing these outputs. Our main output is delivered mail and special services and carrier service to an expanding delivery network. TFP calculations include inputs for all resources including labor, materials, transportation and capital investments.

During 2005, our output per workhour grew 1.4% and our TFP improved 1.1%. This TFP growth is equivalent to $749 million in expense reductions. This marks our sixth consecutive year of TFP growth, equivalent to an expense reduction of over $6.8 billion over this time. Our productivity growth this year was driven primarily by absorbing workload growth. Mail volume grew by 2.7% and delivery points grew by 1.6% contributing to a 1.8% increase in workload. We were able to achieve TFP growth by managing an increased workload with a smaller increase in resource usage. We continue our policy to develop an annual budget so that the net income target also yields positive and sustainable TFP growth.

Capital Investments

The Board of Governors approves the budget for investments in capital property and equipment each year. The Board also approves all major capital projects, generally defined as projects greater than $25 million. The year began with 49 Board-approved projects in progress, representing $5.0 billion in approved capital. Subsequent to the start of FY 2005, lease-only approvals not including a capital investment are no longer tracked as capital investments. As a result, one project was removed from the inventory of Board-approved capital investments during the 2005 year. During the year, the Board approved 8 new projects and modifications to 3 existing projects, totaling $1.9 billion in approved capital. 12 projects, representing $591 million in approved funding, were completed in

TOTAL FACTOR PRODUCTIVITY CUMULATIVE % CHANGE



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2005. Thus, the year ended with 44 projects amounting to $6.4 billion in approved capital.

While the funding for a project is authorized in one year, the commitment, or contract to purchase or build, may occur over several years. By the close of the year, approximately $5.2 billion had been committed for these 44 projects. Similarly, actual payment for the project, or capital cash outlays, may take place over several years. By the end of 2005, approximately $2.5 billion in capital outlays had been paid against commitments made in previous years as well as commitments made in 2005 for these 44 projects.

Of the 44 active Board-approved projects at the close of the year, 24 were for mail processing equipment, 8 for facilities, and 12 for other projects such as retail equipment and information infrastructure support.

Our total capital commitment plan for 2006 is $2.9 billion, with cash outlays planned at $2.4 billion, of which approximately $1.8 billion is for commitments made in prior years and the remaining $600 million for new commitments in 2006.

Our capital plan for the future calls for developing and implementing new automation equipment that will increase our operating efficiency. These programs will reduce workhours in our distribution, processing, and delivery operations. Our primary focus will be on projects that generate a high return on investment. However, we will continue to invest funds to maintain our infrastructure, including facilities, vehicles, and technology systems.

Our facilities program will continue to address life, health, safety, and security issues. We will invest in facilities to support our network requirements. With projected annual average growth of approximately 2 million delivery points each year, we will maintain our infrastructure through high priority replacement projects and ongoing repair and alteration projects.

Finance

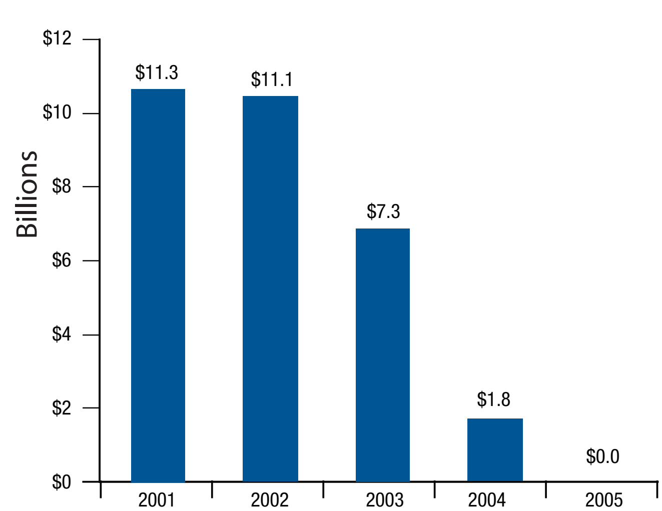
Debt

As an independent establishment of the executive branch of the United States government, we receive no tax dollars for our operations. We are self supporting, and have not received a public service appropriation since 1982. The last time we received any substantial contribution of capital from the U.S. government was in calendar years 1976 and 1977, when we received two $500 million payments which we were required to use to repay operating debt. We fund our operations chiefly from cash generated from operating revenue. However, unlike companies in the private sector, we are not permitted to raise capital through the equity markets. Consequently our only source of outside capital is through securing debt obligations. An additional challenge is that we, unlike the private sector, are not free to set our own prices for our products and services. The postal rate setting process has been a complex and lengthy process in the past. The uncertainty created by this process influences our cash management strategy.

The amount we borrow is largely determined by the difference between our cash flow from operations and our capital cash outlays. Our capital cash outlays are the funds invested back into the business for capital investments in new facilities, new automation equipment, and new services. At the beginning of 2003 our debt stood at $11.1 billion. During that year, we reduced our debt by $3.8 billion and, in 2004 by $5.5 billion. Cash flow from operations in 2005 enabled the repayment of the remaining debt. This is the first time since postal reorganization that we have ended the year with no debt obligations outstanding.

We undertook debt refinancing actions in 2003 that laid the foundation for financial gains in 2004 and 2005. In 2003, we completely overhauled our debt portfolio, paying off all of long-term debt obligations and replacing most of them with short-term debt that would be retired during the

DEBT AT YEAR END

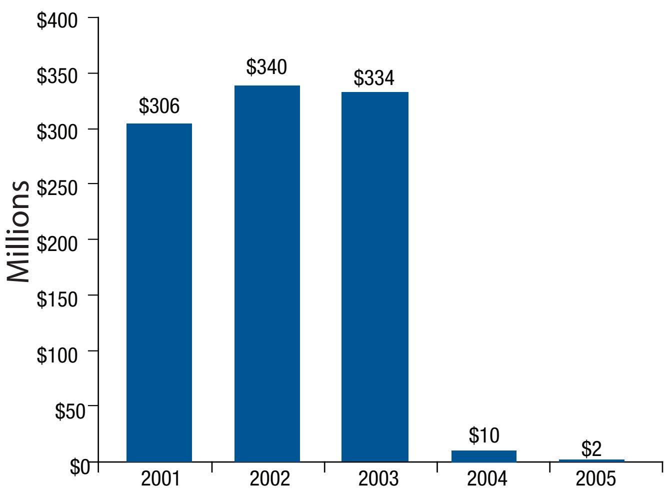


course of 2004. As a result of the overhaul, we benefited from both lower interest rates on short-term debt and also from the flexibility to repay debt with available cash on a daily basis. A major benefit was the reduction in the interest expense payable to the Federal Financing Bank. Reflecting this change, interest expense on borrowings in 2005, was the lowest since postal reorganization. This meant that while we paid an average of $327 million in Interest expense from 2001–2003 we were able to virtually eliminate interest expense in 2004 and 2005.

(Dollars in millions)

Interest and Investment Income	2005	2004	2003
Investment income	$ 60	$ 5	$ 30
Imputed interest on accounts receivable from the U.S. government	25	26	26
Other Interest	1	2	2
Total	**$ 86**	**$ 33**	**$ 58**

OTHER INTEREST EXPENSE



*Other interest expense excludes interest on deferred retirement obligations and the 2003 debt repurchase expense.

We also record imputed interest on the funds owed to us under the Revenue Forgone Act of 1993. Under the Act, Congress is required to reimburse us $29 million annually through 2035. See Note 8 of the Notes to the Financial Statements for additional information.

For 2006, cash flow from operations, after funding the escrow requirement, estimated at $3.1 billion, will not be sufficient to pay for all the capital investments. A projected borrowing of at least $1 billion will be needed to make up the shortfall. Debt levels beyond 2006 will be influenced by our ability to operate at close to break even, and control the level of capital investment. Additionally, our debt levels will also be greatly influenced by the requirements of P.L.108-18, which requires that the "savings" we realize, be held in escrow, and not be obligated or expended until otherwise provided for by law.

Interest and Investment Income

When we determine that our funds exceed our current needs, we invest those funds with the U.S. Treasury's Bureau of Public Debt. We invest primarily in overnight securities issued by the U.S. Treasury. We favor short-term investments because of the nature of our cash flow patterns, and to ensure that our investments are not unnecessarily exposed to the price risk associated with increases in interest rates.

Cash Flow

Net Cash Provided by Operating Activities

During 2005, net cash provided by operating activities decreased $2.2 billion due primarily to increases in compensation and benefits and transportation expenses. Compensation and benefit increases were driven by general salary and COLA pay increases of $1.4 billion, retirement increases of $500 million fueled by an increase of half a percent in the FERS employer contribution cost and current and retiree health benefit increases of more than $400 million. Cash outlays for transportation expenses were approximately $450 million higher than in 2004. A change from recent experience was the decline in the cash payment for workers' compensation in 2005 from 2004 levels. This is the first time that the cash outlays for workers' compensation have decreased year over year. Also the cash payment exceeded the expense for the first time since 1997 reducing the overall workers' compensation liability.

The decrease of $570 million in operating cash flows in 2004 from 2003 was due primarily to increased operating expenses resulting from higher benefit costs. The main driver of these benefit increases was a $697 million or 11.9% increase in retirement costs mainly as a result of a full year of funding CSRS retirement contributions at 17.4% as required by P.L.108-18 and a $180 million or 15.9% increase in retiree health benefit costs. These increases were offset by an additional $247 million in accrued payroll and benefit expenses caused by one additional day of accrued payroll at year end.

Net Cash Used in Investing Activities

During 2005, 2004 and 2003, net cash used in investing activities was $2.3 billion, $1.7 billion and $1.3 billion respectively. The increase in net cash used in investing activities for the last two years reflects increased investment for mail processing equipment, retail equipment and for building improvements. In 2005 capital outlays exceeded depreciation expense for the first time since 2001.

Net Cash Used in Financing Activities

During 2005, we repaid what remained of our prior year-end debt to the Federal Financing Bank, leaving us debt free at year end. There was no mandatory debt reduction provision in the legislation for 2005. Our action this year continues our established practice of going beyond the debt reduction requirements of P.L.108-18. We also received a net appropriation from Congress of $503 million to fund additional biohazard detection systems, ventilation filtration systems and an irradiation facility.

In both 2004 and 2003 the net cash used in financing activities of $5.6 billion and $4.0 billion respectively, reflect our desire, and the requirement of P.L.108-18, that any "savings" generated by the enactment of the law be used to pay down debt. Consequently in 2004 we paid down $5.5 billion in debt and in 2003 we paid down $3.8 billion in debt.

Liquidity

Our liquidity is the cash in the Postal Service Fund in the U.S. Treasury and the amount of money we can borrow on short notice if needed. Our Note Purchase Agreement with the Federal Financing Bank, renewed this year, provides for revolving credit lines of $4 billion. These credit lines enable us to draw up to $3.4 billion with two days notice and up to $600 million on the same business day the funds are needed. Under this agreement we can also use a series of other notes with varying provisions to draw upon with two days notice. The notes provide the flexibility to borrow short-term or long-term, using fixed or floating rate debt, and can be either callable or non-callable. These arrangements with the Federal Financing Bank provide us with adequate tools to effectively manage our interest expense and risk.

The amount of funds we can borrow is limited by the amount of debt authorized by the Board of Governors and by certain statutory limits on borrowing. Our total debt outstanding cannot exceed $15 billion. The net increase in debt for any fiscal year cannot exceed $2 billion for capital purposes and $1 billion to defray operating expenses ($3 billion maximum annual limit).

Our liquidity will be comprised of the cash that we have entering 2006, the cash flow that we can generate from operations, and the $3 billion that can be borrowed if necessary. We do not expect cash flow from operations to supply enough cash to fund both the escrow requirement and our capital investments in 2006. Consequently, we anticipate increasing debt by at least $1 billion. However, this projection is not without risks, and unfavorable events would cause a re-evaluation of the planned 2006 year-end levels of debt.

P.L.108-18 requires that we create an escrow, or restricted cash account of approximately $3.1 billion by September 30, 2006 in the event that Congress has not yet decided how to deploy the savings from change in the retirement funding provisions.

Other Developments

Pending Legislation

POSTAL REFORM

On July 26, 2005, the House of Representatives passed its postal reform bill, H.R. 22, the Postal Accountability and Enhancement Act. On June 22, the Senate Homeland Security and Governmental Affairs Committee approved its bill, S. 662, the Postal Accountability and Enhancement Act. At press time that bill was pending full Senate action. The full text of the proposed legislation can be found at the website *http://thomas.loc.gov/*

On August 2, 2005 the Board of Governors again addressed postal reform. The Statement of Chairman Miller, USPS Board of Governors, regarding postal reform legislation can be found on *usps.com* under News Releases.

On September 13, 2005, the Postal Service Board of Governors wrote letters to the bipartisan leadership of the Senate Committee on Homeland Security and Governmental Affairs and to the House Committee on Government Reform, to clarify the Board's position on postal reform. The Board expressed its concern that the financial relief provided by the escrow and military provisions of both the House and Senate reform bills was threatened by the Administration's Statement of Administration Policy, which stated that the President's senior advisors would recommend that the President veto any enrolled bill that was not budget-neutral. The Board stated that budget-neutral legislation could jeopardize the Postal Service's ability to maintain universal service at reasonable rates. Although both bills provided much needed financial relief through their escrow and CSRS provisions, the Board maintained that neither bill provided the requisite flexibility or authority necessary for the Board to accomplish its mission. Under such circumstances, the Board believed that the Postal Service would be better positioned to build upon its recent success in generating revenue and controlling costs under current law.

SEMIPOSTAL LEGISLATION

On September 27, 2005, the Senate passed S. 37, a bill to extend the sale of the special postage stamp for breast cancer research for 2 years. On October 27, the full House passed S. 37 by voice vote, clearing the measure for the President's signature. The President signed the bill into law on November 11, 2005. The bill extends sales of the *Breast Cancer Research* semipostal stamp through December 31, 2007.

FREE MAILING PRIVILEGES FOR SERVICE-MEMBER FAMILIES

On September 30, 2005 the House Committee on Government Reform approved H.R. 923, a bill to establish a program to provide for free postage on certain mail matter sent to members of the armed forces serving in Iraq and Afghanistan. Under the provisions of the bill, the Secretary of Defense, in consultation with the Postal Service, is required to establish a one-year program under which qualified service members will receive a monthly voucher redeemable to pay for postage for one item, not to exceed 15 pounds in weight, to be mailed to the service member. The service member may send the voucher to an individual of their choosing for this purpose. The bill authorizes an appropriation to the Department of Defense to reimburse the Postal Service for the cost of this free mail benefit. At press time there had been no Senate action on a bill to establish a program to provide for free postage on certain mail matter sent to members of the armed forces serving in Iraq and Afghanistan.

RESERVISTS' PAY

There were several bills that were introduced in the 109th Congress that sought to address the issue of federal employees who are reservists or members of the National Guard who suffer a diminution in federal pay during their period of military service. The financial impact on the Postal Service has been estimated to be $35 to $40 million annually. While the Senate has repeatedly approved amendments on this subject, the amendments have been excluded from the final conference reports.

APPROPRIATIONS

In November 2005, House and Senate Appropriation Committees approved an appropriations bill for 2006 that provides the Postal Service with $29 million for revenue forgone and $87 million to provide free mail for the blind and overseas voters. No funding was provided to complete our emergency preparedness funding. Postal funds, however, may be subject to an across-the-board budget cut, which legislators were discussing at press time.

ENERGY

On August 8, 2005, President Bush signed the comprehensive Energy Policy Act of 2005 (P.L.109-58) into law. The Act sets forth an energy research and development program for the nation. The law requires federal agencies, including the Postal Service, to reduce energy consumption in buildings to meet new energy efficiency goals that will be administered by the Department of Energy.

Provisions in P.L.109-58 will likely impact postal transportation operations, notably by amending the existing Energy Policy Act (EPAct) requirement regarding Flexible Fuel Vehicles (FFVs). P.L.109-58 encourages federal agencies that purchase FFVs in order to comply with EPAct, to actually use alternative fuels by narrowing existing exemptions available to the agencies. Flexible Fuel Vehicles can run on both conventional gasoline and alternative fuel, usually ethanol. Our studies have found ethanol to be 27% less fuel efficient than gasoline when used in postal vehicles. Thus, this provision could impose substantial costs on the Postal Service, including pending vehicle purchases.

IDENTITY THEFT

Several federal identity theft and security breach notification bills were introduced in Congress in 2005. There is growing concern among federal legislators that additional protections to prevent identity theft and notify consumers about personal data being compromised should be enacted. Past experience from the state of California's security breach notification requirement has demonstrated that companies typically notify consumers via the mail. Businesses believe that some federal bill to address these issues will be enacted in 2006.

Financial review
Part II

Transformation Plan

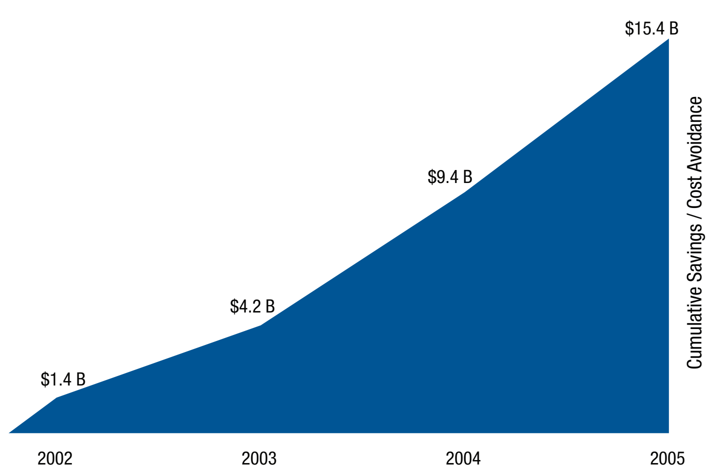
Our *2002 Transformation Plan* has helped us become a leaner, more effective and modern organization. Under this Plan, we attained record levels of service and customer satisfaction and achieved our goal of $5 billion in cost reductions ahead of our 5-year target. The cumulative cost savings under the Plan are over $15 billion.

Postage rates have been stable since 2002 as a result of improvements in productivity and a legislative change that reduced our payments to the Civil Service Retirement Fund. Additionally, we have eliminated outstanding debt from $11.1 billion at the close of 2002 to zero at the end of 2005. Under the *2002 Transformation Plan*, we have been using the flexibility available within current law to think beyond what was perceived as possible only a few years ago.

The *Strategic Transformation Plan 2006–2010*, published in September 2005, is our blueprint for the future. Like the Transformation Plan, published in 2002, it describes how we will improve the value of mail and, by doing so, help sustain a financially stable enterprise that best serves the nation's mailing needs as it provides affordable and reliable universal service. The Plan is organized around our four strategic goals: Generate Revenue; Reduce Costs; Achieve Results with a Customer-Focused, Performance-Based Culture; Improve Service.

This Plan builds upon the momentum of the *2002 Transformation Plan*, while helping to ensure that we can respond to changing customer needs, market requirements, technological developments, and legal requirements. We will continue our commitment to take $1 billion out of the cost base each year through 2010, which, in combination with revenue growth strategies, will sustain our mission of providing universal service at reasonable rates.

TRANSFORMATION PLAN 2002 – 2005



Evolutionary Network Development

We will establish Regional Distribution Centers (RDCs) mainly from existing facilities. In addition to other responsibilities, RDCs will consolidate parcel and bundle distribution to take advantage of shape-based processing and automation efficiencies, as well as function as consolidated transfer points for all mail.

We are expanding our transportation surface reach through the creation of Surface Transfer Centers which will provide consolidation opportunities to maximize vehicle capacity and eliminate redundant transportation. For those products that must remain in the air we are creating partnerships that allow us to purchase a low cost air solution. Through these efforts we are creating a flexible logistics network that reduces costs, increases operational effectiveness, and improves the consistency of service.

In the last decade a combination of changes in mail mix/mailer behavior and Postal Service automation capability provides the opportunity to consolidate and streamline postal processing.

In 2005 with the volume of Standard Mail exceeding First-Class Mail, the proportion of mail drop shipped into the postal network in downstream locations continues to increase. With single piece First-Class Mail volume continuing its eight year decline there are less cancellations and processing at originating processing centers. As workshare First-Class Mail volume increases it, too, bypasses originating operations and is first processed on automation at destinating network facilities.

Further, Postal Service automation has not only provided significant efficiency increases, but it also has higher throughput rates and is more flexible. For example, the new Automated Package Processing System (APPS) sorts bundles and packages. The combination of changes in our customers' mail and mailing patterns, and improvements in postal automation provides the opportunity to consolidate processing classes of mail. That consolidation yields less complex transportation network requirements, which will be less expensive.

Outlook

Even before the recent hurricanes took their toll on the economy, we expected economic growth in 2006 to slow down. Hurricanes Katrina and Rita dealt a significant blow to the nation's energy infrastructure. Oil producing platforms and oil refineries were shut down. The growth in the U.S. economy in the last two years had been largely due to growth in consumer spending and the housing market. Consumer spending growth in 2006 is expected to weaken as energy costs squeeze spending power. The Federal Reserve increased the federal funds rate at its November 2005 meeting indicating that it is more worried about the inflationary risk rather than downside growth risks. Higher interest rates are expected to slow the growth in the housing market.

We requested and the PRC issued a Decision that postage rates be increased by 5.4% across-the board. The new rates, accepted by the Board of Governors on November 14, 2005, will be implemented January 8, 2006.

With the projected 2006 retail sales slowdown and the expected rate increase, we project a lower growth rate for Standard Mail volume and a small volume decline in workshare First-Class Mail. Economy-wide retail sales, an economic indicator for Standard Mail and workshare First-Class Mail, grew 5.0% in 2005, but we expect them to slacken as a result of increased energy prices and interest rates. Increased energy prices reduce consumer's purchasing power thus diverting consumer expenditures from other goods and services, and higher interest rates will dampen the demand in the housing sector. With decreased mortgage refinancing, less cash is available to consumers for large purchases.

Even with the pause in 2005, we do not foresee a reversal of the multiyear downward trend in total First-Class Mail volume. Looking at single-piece and workshare First-Class Mail volume together, we can see that economic growth has only slowed the declines in First-Class Mail volume and revenue in 2005. With a projected slowdown in economic growth in 2006, our forecast is for First-Class Mail volume to decline in 2006.

Priority Mail volume, which showed positive growth in 2005 after four years of decline, is forecast to be flat in 2006 due to the slowdown in the economy coupled with a rate increase. Express Mail has a highly elastic demand. As in the case of Priority Mail, the rate affect will overpower increases in volume due to economic growth in the economy, leading to a decline in the 2006 volume. The growth we forecast in Package Services is based on projected increases in both Bound Printed Matter and Media Mail volumes, even though we expect a decline in Parcel Post. Building the business to exceed these forecasts is a major priority in 2006.

We project revenues to increase by $2.3 billion, or 3.4% to $72.3 billion in 2006. Most of this increase is due to the requested rate increase which will be implemented January 8, 2006.

Network Growth

Historically, First-Class Mail volume and the growth in contribution it has produced have financed the cost of operating and expanding our universal delivery network. Over the last several years, however, the volume of First-Class Mail has declined while the number of delivery points in our network has continued to increase. Since 2001, First-Class Mail volume has decreased by over 5.6 billion pieces while our delivery network has expanded through the addition of 6.6 million new delivery points. Furthermore, we operate a retail network anchored by over 37,000 Post Offices, stations, branches and contract units.

Delivering mail to individual delivery points six days a week is a major part of our work. Each year, we add over 1.8 million delivery points to our network. In 2004, we adjusted our reporting of rural and highway contract deliveries to customers who have their mail forwarded to a Post Office box as an alternative to a physical address. Prior to 2004 we included both addresses in our count of "possible" delivery points. We also no longer count a vacant delivery point on rural and highway routes as "possible" delivery points. These adjustments reduced our total delivery points by 824,388, and we have therefore adjusted our 2004 Operating Statistics in last year's report to reflect this change. Our actual growth in delivery points in 2004 and 2005 were 1,782,900 and 2,006,577 respectively.

We expect the number of delivery points to continue to grow for the indefinite future as a result of population growth and continuing demand for new housing. The Bureau of the Census reported housing starts in August 2005 at a seasonally adjusted rate of 1.8 to 2 million. Also, Harvard University's Joint Center for Housing Studies reported that "Demand for new homes is on track to total as many as 20 million units between now and 2015." This projected increase in household growth will translate into a continuing expansion of our delivery network. In the same period, First-Class Mail volume is projected to continue to decline. As the revenue and contribution produced by First-Class Mail decline, we will lose our primary historic means of financing our delivery and retail networks. This combination of trends will continue to challenge us to build all other postal business to continue to finance the nation's universal delivery system.

Financial review
Part II

Impact of Inflation and Changing Prices

The Postal Reorganization Act requires that we provide universal mail service and set postal rates and fees so that total estimated revenues of our organization equal our total estimated costs. Our primary costs are for labor and the related cost of benefits, transportation, utilities, material costs, and the cost of maintaining, replacing and expanding our retail and distribution network.

We have maintained stable prices since the implementation of the last omnibus rate case recommendation in the summer of 2002, and will maintain them until January 2006. We achieved this through continuous productivity improvement and from the benefit of reduced CSRS retirement costs of P.L.108-18. We plan to continue mitigating inflationary pressure with $1.1 billion of cost reductions planned for 2006. But these productivity improvements alone will not offset the continuing upward cost pressures resulting from resource cost inflation, the continuous expansion of our delivery network, and the loss of First-Class Mail volume and its high level of contribution to institutional costs.

Expense Growth

We estimate that total expenses in 2006 will be $71.1 billion, a 3.7% increase over our 2005 expenses of $68.6 billion. We expect personnel compensation and our cost per workhour to increase. This increase will be driven by higher cost-of-living pay adjustments, health benefit inflation and delivery network expenses.

We expect non-personnel expenses, excluding transportation expenses, to increase approximately $350 million, or 3.9%. Increased costs to deploy and operate systems to protect postal employees and the public from biological agents that could be introduced into the mail stream account for over $100 million of the growth. Investments in programs to update and improve information technology capabilities, and improvements to customer access and service are also main drivers for 2006. Transportation expenses are expected to grow $300 million, or 5.7% over 2005 due to higher fuel costs.

The 2006 plan reduces workhours by 42 million below the 2005 total. This would be the sixth out of the last seven years in which we have reduced workhours. The 2006 planned workhour reduction target is equal to approximately 20,000 full-time equivalent employees. The workhour reductions rely primarily on process improvements, rather than on capital investment programs for achievement. Mail volume is projected to increase slightly in 2006 and sizeable efficiency gains have already been realized through workhour reductions.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market Risk Disclosure

In the normal course of business, we are exposed to market risk from changes in commodity prices, certain foreign currency exchange rate fluctuations, and interest rates. With the limited exception explained on the following page, we do not use derivative financial instruments to manage market risks. Additionally, we do not purchase or hold derivative financial instruments for speculative purposes.

Revenue

Revenue is a function of the volume and mix of mail. As noted, mail volume trends have provided a lower revenue-per-piece mix. If this accelerates beyond what has been projected, it will have an adverse effect on revenue.

Economic Risk

Retail sales and employment, key drivers of workshare First-Class Mail and Standard Mail, have grown strongly in the last two years. Recent economic news, however, shows a significant downside risk to economic growth. Increases in energy costs, speculation about the housing market, the double deficits (i.e., the international trade and federal government deficits), unprecedented rates of personal consumption expenditures and non-mortgage consumer credit, and rising interest rates are all cause for concern.

General Inflation Risk

Each of our labor contracts with our largest unions includes provisions granting COLAs. These adjustments are generally granted semi-annually and are linked to increases in the consumer price index (CPI). Nonbargaining employees do not receive COLAs. Because employee compensation represents a significant portion of our annual expenses, an increase in the CPI greater than had been incorporated into our financial plans could be a significant risk to our financial results. We estimate that an increase in the CPI of 0.5% would cause an annualized increase in our COLAs of about $100 million.

Commodity Price Risk

We estimate that we purchase approximately 800 million gallons of fuel each year. Thus fuel prices are a significant part of our expenses.

We are exposed to changes in commodity prices primarily for diesel fuel, unleaded gasoline, and aircraft fuel for transportation of the mails and natural gas for heating facilities. We currently do not use derivative commodity instruments to manage the risk of changes in energy prices.

Foreign Currency Exchange Rate Risk

We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail. The majority of our international accounts are accounted for based on International Monetary Fund special drawing rights (SDR). The SDR exchange rate fluctuates daily based on a basket of currencies comprised of the euro, the Japanese yen, the pound sterling, and the U.S. dollar. Changes in the relative value of these currencies will increase or decrease the value of our settlement accounts and result in a gain or loss from revaluation. The actual currency used to settle accounts varies by country based on individual agreements.

We purchase the required currency at the time of settlement, but when we know the timing and the amount of scheduled payments in advance, we may purchase short duration forward contracts.

At year end, we adjust the reported receivable and payable balances to reflect the fair value based on the SDR rate published in the Wall Street Journal on the last day of September. This resulted in a $10 million gain from the revaluation in 2005 as well as a gain of $10 million in 2004. We do not use derivative financial instruments to manage the risk of changes in the value of the SDR.

Interest Rate Risk

We have not used derivative financial instruments to manage risk related to interest rate fluctuations for debt instruments.

We estimate that a 1.0% increase in interest rates would have an insignificant impact on our financial statements due to the structure of our investment portfolio.

Item 8. Financial Statements

Financial statements are on pages 41–53 of this report.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Management is responsible for the preparation, integrity, and fair presentation of the financial statements of the Postal Service.

We maintain a system of internal control over financial reporting that is designed to provide reasonable assurance that transactions are executed as authorized and accurately recorded, that assets are safeguarded, and accounting records are sufficiently reliable to permit the preparation of financial statements that conform to accounting principles generally accepted in the United States. We maintain disclosure controls and procedures designed to ensure that information to be disclosed by us is recorded, processed, summarized, and reported within the time periods specified by our Board of Governors and the Office of Management and Budget. We are monitoring our internal controls over financial reporting and disclosure controls and procedures through internal self-assessments.

Code of Ethics

The Standards of Ethical Conduct for Employees of the Executive Branch at 5 Code of Federal Regulations (C.F.R.) §2635 apply to all postal employees. The Standards were issued in 1993 by the U.S. Office of Government Ethics, and replaced the individual agency standards then applicable to all employees of the executive branch. Our employees are also covered by the Supplemental Standards of Ethical Conduct for Employees of the United States Postal Service at 5 C.F.R. §7001. The Standards and Supplemental Standards are detailed and contain many examples to help employees recognize and resolve ethical issues. We give employees a summary of the standards, and other ethical conduct materials, at new employee orientation training and other times during the year. We also provide annual ethics training for all employees who file a financial disclosure report. We encourage our employees to seek ethics advice and information from internal ethics officials, and we publicize an ethics telephone line and e-mail address they can use for this purpose.

Financial review
Part III

Item 10. Directors and Executive Officers

Executive Committee

John E. Potter
Postmaster General and CEO

Patrick R. Donahoe
Deputy Postmaster General and Chief Operating Officer

Anita J. Bizzotto
Chief Marketing Officer and Executive Vice President

Richard J. Strasser, Jr.
Chief Financial Officer and Executive Vice President

Anthony J. Vegliante
Chief Human Resources Officer and Executive Vice President

Mary Anne Gibbons
Senior Vice President and General Counsel

Thomas G. Day
Senior Vice President, Government Relations

Linda A. Kingsley
Vice President, Strategic Planning

Officers

Nicholas F. Barranca
Vice President, Product Development

Sylvester Black
Vice President, Area Operations (Western)

Charles E. Bravo
Senior Vice President, Intelligent Mail and Address Quality

Megan J. Brennan
Vice President, Area Operations (Northeast)

William J. Brown
Vice President, Area Operations (Southeast)

Ellis A. Burgoyne
Vice President, Delivery and Retail

James A. Cohen
Judicial Officer

Jo Ann Feindt
Vice President, Area Operations (Great Lakes)

William Galligan
Senior Vice President, Operations

DeWitt O. Harris
Vice President, Employee Resource Management

Lee R. Heath
Chief Postal Inspector

Alfred Iniguez
Vice President, Area Operations (Pacific)

Azeezaly S. Jaffer
Vice President, Public Affairs and Communications

Stephen M. Kearney
Vice President, Pricing and Classification

Delores Killette
Vice President, Consumer Advocate

Susan M. LaChance
Vice President, Employee Development and Diversity

Keith LaShier
Vice President, Facilities (acting)

Alexander Lazaroff
Vice President, Area Operations (Eastern)

George L. Lopez
Vice President, Area Operations (Southwest)

Lynn Malcolm
Vice President, Controller

Walter F. O'Tormey
Vice President, Engineering

Robert L. Otto
Vice President, Chief Technology Officer

Henry A. Pankey
Vice President, Emergency Preparedness

Robert J. Pedersen
Vice President, Treasurer

Susan Plonkey,
Vice President, Customer Service

David L. Solomon
Vice President, Area Operations (New York Metro)

Michael F. Spates,
Vice President, Consumer Advocate (acting)

A. Keith Strange
Vice President, Supply Management

Douglas A. Tulino
Vice President, Labor Relations

Paul Vogel
Vice President, Network Operations Management

James P. Wade
Vice President, International Business

Jerry W. Whalen
Vice President, Sales

Item 11. Executive Compensation

The Postal Service releases information concerning executive compensation to the extent required by the Freedom of Information Act (FOIA), 5 United States Code (U.S.C.) 552. Postal Service regulations implementing the FOIA are located at 39 C.F.R. 265. Information regarding how to submit a FOIA request can be found on our website *usps.com.*

Item 12. Security Ownership of Certain Beneficial Owners and Management Related Stockholder Matters

Not applicable to this report.

Item 13. Certain Relationships and Related Transactions

As discussed in Item 9A, every Postal Service officer, manager, and employee is required to comply with the Standards of Ethical Conduct for Employees of the Executive Branch and by the Supplemental Standards of Ethical Conduct for Employees of the United States Postal Service.

Item 14. Principal Accountant Fees and Services

In 2002, the Board of Governors selected Ernst & Young LLP as its independent auditor to perform external auditing services. The competitively awarded five-year contract, with an option of renewal of up to 36 months, has an estimated value of $11.7 million. This contract covers the financial statement audits for fiscal years 2003–2007. As with previous contracts for external audit services, Ernst & Young LLP will not perform consulting work for us for the duration of its contract.

Report of independent auditors

ERNST & YOUNG

■ Ernst & Young LLP
8484 Westpark Drive
McLean, VA 22102

■ Phone: (703) -747-1000
www.ey.com

Report of Independent Auditors

Board of Governors
United States Postal Service

We have audited the accompanying balance sheets of the United States Postal Service as of September 30, 2005 and 2004, and the related statements of operations, changes in net capital (deficiency) and cash flows for each of the three years in the period ended September 30, 2005. These financial statements are the responsibility of the United States Postal Service's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the United States Postal Service's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the United States Postal Service's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the United States Postal Service as of September 30, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2005 in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 14, 2005 and November 10, 2004, for fiscal years 2005 and 2004, respectively, on our consideration of the United States Postal Service's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Ernst + Young LLP

McLean, VA
November 14, 2005

Statement of operations

(Dollars in millions)	Year Ended September 30,		
	2005	2004	2003
Operating revenue	$ 69,907	$ 68,996	$ 68,529
Operating expenses:			
Compensation and benefits	53,932	52,134	50,428
Transportation	5,437	4,969	4,989
Other	8,914	8,748	8,485
Total operating expenses	**68,283**	**65,851**	**63,902**
Income from operations	1,624	3,145	4,627
Interest and investment income	86	33	58
Interest expense on deferred retirement obligations	(263)	(103)	(116)
Debt repurchase expense	–	–	(360)
Other interest expense	(2)	(10)	(334)
Emergency preparedness appropriations	–	–	177
Emergency preparedness expenses	–	–	(184)
Net Income	**$ 1,445**	**$ 3,065**	**$ 3,868**

See accompanying notes to the financial statements.

Balance Sheets – Assets

(Dollars in millions)	September 30, 2005	2004
Assets		
Current Assets:		
Cash and cash equivalents	$ 930	$ 877
Receivables:		
Foreign countries	590	621
U.S. government	280	327
Other	188	187
Receivables before allowances	1,058	1,135
Less allowances	50	111
Total receivables, net	1,008	1,024
Supplies, advances and prepayments	200	220
Total Current Assets	**2,138**	**2,121**
Other Assets, Principally Revenue Forgone Appropriations Receivable	**376**	**361**
Property and Equipment, at Cost:		
Buildings	20,480	20,171
Equipment	18,664	17,277
Land	2,878	2,810
Leasehold improvements	1,172	1,103
	43,194	41,361
Less allowances for depreciation and amortization	22,400	20,656
	20,794	20,705
Construction in progress	1,895	1,792
Total Property and Equipment, Net	**22,689**	**22,497**
Total Assets	**$ 25,203**	**$ 24,979**

See accompanying notes to the financial statements.

Balance Sheets – Liabilities & Equity

(Dollars in millions)	September 30, 2005	2004
Liabilities and Net Capital		
Current Liabilities:		
Compensation and benefits	$ 2,852	$ 2,640
Estimated prepaid postage	1,200	1,256
Payables and accrued expenses:		
Commercial vendors and accrued expenses	1,568	1,711
Foreign countries	688	778
U.S. government	76	87
Total payables and accrued expenses	2,332	2,576
Customer deposit accounts	1,720	1,606
Outstanding postal money orders	830	767
Prepaid box rent and other deferred revenue	477	425
Debt	–	1,800
Total Current Liabilities	**9,411**	**11,070**
Non-Current Liabilities:		
Workers' compensation costs	6,695	6,651
Employees' accumulated leave	2,016	2,006
Deferred revenue	692	288
Long term portion capital lease obligations	644	652
Other	369	381
Total Non-Current Liabilities	**10,416**	**9,978**
Total Liabilities	**19,827**	**21,048**
Net Capital		
Capital contributions of the U.S. government	3,034	3,034
Retained earnings since reorganization	2,342	897
Total Net Capital	**5,376**	**3,931**
Total Liabilities and Net Capital	**$ 25,203**	**$ 24,979**

See accompanying notes to the financial statements.

Statements of changes in net capital

(Dollars in millions)	Year ended September 30, 2005, 2004 and 2003		
	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital (Deficiency)
Balance, September 30, 2002	$ 3,034	$ (6,036)	$ (3,002)
Net Income	–	3,868	3,868
Balance, September 30, 2003	3,034	(2,168)	866
Net income	–	3,065	3,065
Balance September 30, 2004	3,034	897	3,931
Net income	–	1,445	1,445
Balance, September 30, 2005	**$ 3,034**	**$ 2,342**	**$ 5,376**

See accompanying notes to the financial statements.

Statements of cash flows

(Dollars in millions)	Year ended September 30,		
	2005	2004	2003
Cash flows from operating activities:			
Net income	$ 1,445	$ 3,065	$ 3,868
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,089	2,145	2,295
Loss on disposals of property and equipment, net	5	71	64
(Increase) decrease in revenue forgone appropriations receivable	(15)	4	3
(Decrease) increase in workers' compensation liability	(58)	343	526
Increase (decrease) in employees' accumulated leave	10	74	(156)
(Decrease) increase in other non-current liabilities	(119)	170	(31)
Changes in current assets and liabilities:			
Decrease (increase) in receivables, net	16	167	(394)
Decrease (increase) in supplies, advances and prepayments	20	146	(39)
Increase (decrease) in compensation and benefits	314	106	(427)
Decrease in estimated prepaid postage	(56)	(93)	(151)
(Decrease) increase in payables and accrued expenses	(199)	(34)	1,378
Increase (decrease) in customer deposit accounts	114	40	(138)
Increase (decrease) in outstanding postal money orders	63	(1)	(218)
Increase (decrease) in prepaid box rent and other deferred revenue	52	(368)	(175)
Net cash provided by operating activities	3,681	5,835	6,405
Cash flows from investing activities:			
Purchase of property and equipment	(2,317)	(1,685)	(1,314)
Proceeds from sale of property and equipment	31	26	37
Net cash used in investing activities	(2,286)	(1,659)	(1,277)
Cash flows from financing activities:			
U.S. government appropriations – received	503	–	–
U.S. government appropriations – expended	(45)	(92)	(177)
Issuance of debt	–	–	4,609
Payments on debt	(1,800)	(5,473)	(8,450)
Net cash (used in) provided by financing activities	(1,342)	(5,565)	(4,018)
Net (decrease) increase in cash and cash equivalents	53	(1,389)	1,110
Cash and cash equivalents at beginning of year	877	2,266	1,156
Cash and cash equivalents at end of year	**$ 930**	**$ 877**	**$ 2,266**

See accompanying notes to the financial statements.

Notes to the financial statements

Note 1 – Description of Business

Nature of Operations

The United States Postal Service provides mail service to the public, offering a variety of classes of mail services without undue discrimination among its many customers. This means that within each class of mail our price does not unreasonably vary by customer for the levels of service we provide. This fulfills our legal mandate to offer universal service at a fair price. Our primary lines of business are First-Class Mail, Standard Mail, Priority Mail, International Mail, Express Mail, Periodicals and Package Services. The principal markets for these services are the communications, distribution and delivery, advertising and retail markets. Our products are distributed through more than 37,000 Post Offices, stations and branches, contract postal units and a large network of consignees. We conduct our significant operations primarily in the domestic market, with international operations representing less than 3% of our total revenue.

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Almost 90% of our career employees are covered by collective bargaining agreements. The agreements with the major unions expire November 20, 2006.

By law, we also consult with management organizations representing most of the employees not covered by collective bargaining agreements. These consultations provide an opportunity to participate directly in the planning, development, and implementation of programs and policies affecting the managerial employees in the field. The management organizations include the National Association of Postal Supervisors, National League of Postmasters, and National Association of Postmasters of the United States. We participate in federal employee benefit programs covering retirement, health benefits, and workers' compensation.

Postal Reorganization

We commenced operations on July 1, 1971, in accordance with the provisions of the Postal Reorganization Act (the Act). The equity that the U.S. government held in the former Post Office Department became our initial capital. We valued the assets of the former Post Office Department at original cost less accumulated depreciation. The initial transfer of assets, including property, equipment and cash, totaled $1.7 billion. Subsequent cash contributions and transfers of assets between 1972 and 1982 totaled approximately $1.3 billion, resulting in total government contributions of approximately $3 billion. The U.S. government remained responsible for all the liabilities attributable to operations of the former Post Office Department; however, under the Balanced Budget Act of 1997, the remaining liability for Post Office Department workers' compensation costs was transferred to us.

Although we are excluded from the U.S. government budgetary process, we do enter into significant transactions with other government agencies, as disclosed throughout these financial statements.

Price Setting Process

Since 1971, the Act has required us to establish prices that cover the costs of operating the postal system. The Act established the independent Postal Rate Commission with oversight responsibility for mail prices, subject to approval by the Governors of the Postal Service. The ratemaking process provides for the recovery of financial losses through future rate increases.

Note 2 – Summary of Significant Accounting Policies

Basis of Accounting and Use of Estimates

We maintain our accounting records and prepare our financial statements on the accrual basis of accounting. This basis conforms to accounting principles generally accepted in the United States. Following these principles, we make estimates and assumptions that affect the amounts we report in the financial statements and notes. Actual results may differ from our estimates.

Cash and Cash Equivalents

Cash equivalents are securities that mature within 90 days or less from the date we buy them. We recognize checks outstanding as a current liability until presented for payment.

Current Values of Financial Instruments

The current value of our debt is what it would cost to pay off the debt if we used the current yield on equivalent U.S. Treasury debt.

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

The impact on the statements of operations from this revaluation was a gain of $10 million in 2005, a gain of $10 million in 2004, and a loss of $9 million in 2003. In addition to the year end revaluation, we also recognize gains and losses on our payables and receivables when we settle with foreign postal administrations. The impact on the statements of operations from these settlements was a loss of $14 million in 2005, $15 million in 2004 and $12 million in 2003.

Supplies, Advances and Prepayments

Supplies, advances and prepayments are primarily composed of our inventories of supplies, motor vehicle parts and parts for mail processing equipment. We value our inventories at the lower of average cost or current market price. Total inventories amounted to $119 million at the end of 2005 and $118 million at the end of 2004.

Property and Equipment

We record property and equipment at what it cost us to acquire the assets, including the interest we pay on the money we borrow to pay for the construction of major capital additions. No interest was capitalized in 2005 as no outstanding debt balance was carried for this period. In 2004, interest was capitalized in the amount of $5 million and $1 million in 2003. Repairs and maintenance are charged to expense as incurred. This expense amounted to $809 million in 2005, $744 million in 2004 and $692 million in 2003.

We depreciate buildings and equipment over their estimated useful lives, which range from 3 to 75 years, using the straight-line method. We amortize leasehold improvements over the period of the lease or the useful life of the improvement, whichever time is shorter.

Impaired Assets

We record losses on long-lived assets when events and circumstances indicate that the assets might be impaired. In accordance with Statement of Financial Accounting Standards (FAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, we have written down our impaired assets to the lower of cost or fair value. On August 29, 2005 hurricane Katrina devastated the gulf coast and damaged many of our facilities in that area. As of September 30, 2005 we have recorded an estimate for impaired assets in the amount of $7.5 million. In 2004 we determined that an unused Post Office building in a major city was impaired. A contract granting a prospective buyer an option to buy this building was signed. This option was contingent on our making all necessary repairs to the building. An impairment loss of $24 million was recorded in 2004 in order to reduce the carrying value of the property to its estimated fair value, including the cost of necessary repairs. No material impairments were recorded in 2003.

Allowance for Doubtful Accounts

We provide an allowance for doubtful accounts on our outstanding receivables based on our collection history and an estimate of uncollectible accounts. In 2005 we re-evaluated our allowance for bad debt methodology, based on our last five years of collection history. This change in estimate was the primary driver that reduced our allowance for doubtful accounts from $111 million in 2004 to $50 million at the end of 2005.

Revenue Recognition/Estimated Prepaid Postage

We recognize revenue when service is rendered. Estimated prepaid postage is the amount of cash we estimate that we collected by the end of the year for services that we will perform in the following year.

Compensation and Benefits Payable

This is the salaries and benefits we owe to current and retired employees, including the amounts employees have earned but have not yet been paid, current workers' compensation, unemployment costs and health benefits.

Outstanding Postal Money Orders

We sell money orders to the general public at our retail locations. We charge a fee to the customer at the time of sale. The fee is recognized as revenue at the time of sale. We recognize a liability for uncashed money orders we expect to be presented for payment.

Segment Information

We operate in one segment throughout the United States and internationally.

Deferred Retirement Benefits and Cost

We are an independent establishment of the executive branch of the U.S. government. We provide pension benefits as defined and administered by OPM and, therefore, have a parent-subsidiary type relationship. We cannot direct the costs, benefits, or funding requirements of the federally-sponsored plan. We account for our participation in the U.S. government sponsored retirement plans as a participant in a multi-employer plan arrangement in accordance with FAS 87, *Employers' Accounting For Pension Costs*. See notes 6 and 7 for additional information.

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). FEHBP is sponsored by the U.S. government. We cannot direct the costs, benefits, or funding requirements of the federally-sponsored plan. We account for our participation in FEHBP as a participant in a multi-employer plan arrangement in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* Therefore, the costs of retiree health benefits are expensed as we incur them. See note 4 for additional information.

Workers' Compensation Cost

We are self-insured for workers' compensation costs under a program administered by the Department of Labor (DOL). These costs include employees' medical expenses and payment for continuation of wages. We record these costs as an operating expense.

Our liability at September 30, 2005 represents the estimated present value of the total amount we expect to pay in the future for postal workers injured through the end of 2005. The estimated total cost of a claim is based upon the severity of the injury, the age of the injured employee, the assumed life expectancy of the employee, the trend of our experience with such an injury, and other factors. In our calculation of present value for 2005 and 2004, a net discount rate of -0.8% for medical expenses and 3.3% for compensation claims is used. During 2004 we changed these discount rates in order to more accurately reflect our liability. See note 3 for additional information.

Emergency Preparedness Appropriations

Emergency preparedness appropriations are the funds we receive from the federal government to help pay the costs to keep the mail, postal employees and postal customers safe and are restricted to such use. Upon receipt of the funds, we established a liability. Through 2003 we recognized these funds as non-operating revenue to the extent of the qualifying non-operating expenditure. In 2004 we began recognizing these funds as operating revenue to the extent they offset operating expenses. The appropriations we use to purchase capital equipment will be offset against the depreciation expense over the life of the equipment. See note 11 for additional information.

Reclassifications

Certain comparative prior year amounts in the financial statements and accompanying notes have been reclassified to conform to the current year presentation. These reclassifications had no effect on previously reported operating income and net income.

Note 3 – Workers' Compensation

At the end of 2005, we estimate our total liability for future workers' compensation costs at $7,521 million. At the end of 2004 this liability was $7,579 million. The payout period for this liability will, for some claimants currently on the rolls, be for the rest of their lives. The liability is sensitive to changes in inflation and discount rates. An increase of 1% in the assumptions would decrease our estimate of the liability by approximately $655 million. A decrease of 1% would increase our estimate of the liability by approximately $801 million.

In 2005, we recorded $838 million in workers' compensation expense, compared to the $1,239 million we recorded in 2004 and the $1,473 million we recorded in 2003.

In 2004, we changed the net discount rates used to determine the present value of estimated future workers' compensation payments, in consultation with an independent actuary. Our net discount rate is the estimated difference between what we expect to earn on investments compared to what we assume the inflation rate will be for medical costs and wage increases. Our net discount rate of -0.8% for medical claims means that our assumptions show that the average rate of inflation for medical claims (5.5%) will exceed our investment returns (4.7%) by 0.8% per year over the expected life of the medical claims. Conversely we believe that our assumed investment returns (5.5%) will exceed the rate of inflation on the consumer wages index (2.2%) by 3.3% over the expected life of the compensation claims.

In 2004, we reduced the medical claims net discount rate from 1.4% to -0.8% resulting in an increase in our medical claims liability and expense of $362 million. We increased the compensation claims net discount rate from 3.0% to 3.3%, thereby reducing that liability and expense by $148 million. These combined changes increased our total workers' compensation liability and expense by $214 million. The effect of the adoption of these changes is accounted for as a change in accounting estimate.

In addition to the cost of workers' compensation claims, OWCP charges us an administrative fee for processing claims. In 2005, the administrative fee, included in the expense above, was $56 million, compared to $44 million in 2004 and $45 million in 2003.

Note 4 – Health Benefit Programs

Substantially all of our employees are covered by the U.S. government health plan, the Federal Employees Health Benefits Program (FEHBP). The Office of Personnel Management administers the program and allocates the cost of the program to the various participating government agency employers. The parent-subsidiary relationship that we have as an "independent establishment" of the executive branch of the United States government allows for this accounting treatment. We cannot direct the costs, benefits, or funding requirements of the federally-sponsored plan.

Our portion of the cost is based upon the average premium cost of the various employee coverage choices and the specific coverage choices made by our employees. Our employees paid approximately 16% of the cost in 2005, 2004, and 2003, and we paid the remainder.

Our employees who participate in the FEHBP for at least the five years immediately before their retirement may participate in the FEHBP during their retirement. The Omnibus Budget Reconciliation Act of 1990 requires us to pay the employer's share of health insurance premiums for all employees and their survivors, who participate in the FEHBP and who retire on or after July 1, 1971. However, we do not include the costs attributable to federal civilian service before that date.

We account for retiree health benefits as a participant in a multi-employer plan arrangement in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* Our retiree health benefit expenses amounted to $1,495 million in 2005, $1,313 million in 2004 and $1,133 million in 2003. We include these costs in our compensation and benefits expense.

Note 5 – Debt And Related Interest Cost

Under the Postal Reorganization Act, as amended by Public Law 101-227, we can issue debt obligations. However, we are limited to net annual increases of $2 billion in our debt for capital improvements and $1 billion for operating expenses. Our total debt cannot exceed $15 billion.

Cash outlays for interest, including interest on the retirement "supplemental liability," discussed in note 7, were $263 million in 2005, $242 million in 2004, and $426 million in 2003.

In January, July, and August 2003, we repaid debt with maturity dates that extended to 2031. In connection with the August transaction, we paid a premium (debt repurchase expense) of $360 million which was expensed when incurred.

At September 30, 2005 no debt was outstanding on our balance sheet. At September 30, 2004 the market value of our debt was $1,800 million. This debt consisted of $1,800 million in cash drawn on our line of credit with the Federal Financing Bank.

Our Note Purchase Agreements with the Federal Financing Bank, renewed this year, provide for revolving credit lines of $4 billion. These credit lines enable us to draw up to $3.4 billion with two days' notice and up to $600 million on the same business day the funds are needed. Under these agreements we can also use a series of other notes with varying provisions to draw upon with two days' notice. The notes provide us the flexibility to borrow short-term or long-term, using fixed or floating rate debt, and can be either callable or non-callable.

Note 6 – Retirement Programs

Our employees, retirees, and their survivors participate in pension programs of the U.S. government. We account for our involvement in these programs as participation in a multi-employer plan arrangement, in accordance with FAS 87, *Employers' Accounting for Pensions.* The parent-subsidiary relationship that we have as an "independent establishment" of the executive branch of the United States government allows for this accounting treatment. We cannot direct the costs, benefits, or funding requirements of the federally-sponsored plan.

With certain exceptions, employees participate in one of the following three retirement programs based upon the starting date of their employment with the Federal Government. Employee and employer contributions are made to the Civil Service Retirement System (CSRS), the Dual Civil Service Retirement System/ Social Security (Dual CSRS), or the Federal Employees Retirement System (FERS), which are administered by the Office of Personnel Management. Employees may also participate in the Thrift

Notes to the financial statements

Savings Plan, which is a defined contribution retirement savings and investment plan. Postal Service employees are authorized to participate in the Thrift Savings Plan by the Federal Employees Retirement System Act of 1986. The Plan is administered by the Federal Retirement Thrift Investment Board.

CSRS

Under the Postal Reorganization Act, officers and career employees hired prior to January 1, 1984 are covered by the Civil Service Retirement System, which provides a basic annuity toward which we and the employee contribute. We do not match contributions to the Thrift Savings Plan for employees who participate in the CSRS.

Dual CSRS

Employees with prior U.S. government service who were hired between January 1, 1984, and January 1, 1987, are covered by the Dual Civil Service Retirement System/Social Security System, which consists of a basic annuity and Social Security. We and the employee contribute to Social Security and the basic annuity at the rate prescribed by law. We do not match contributions to the Thrift Savings Plan for employees who participate in the Dual System.

FERS

Effective January 1, 1987, officers and career employees hired since December 31, 1983, except for those covered by the Dual System, are covered by the Federal Employees Retirement System Act of 1986. In addition, employees hired before January 1, 1984, could choose during certain periods in 1987, 1988 and 1998 to participate in the FERS. This system consists of Social Security, a basic annuity plan, and a Thrift Savings Plan. We and the employee contribute to Social Security and the basic annuity plan at the rate prescribed by law. In addition, we are required to contribute to the Thrift Savings Plan a minimum of 1% per year of the basic pay of employees covered by this system. We also match a voluntary employee contribution up to 3% of the employee's basic pay, and 50% of a contribution between 3% and 5% of basic pay.

Employer and employee base contributions, as a percentage of employee basic pay, are as follows for each of the three plans for 2005, 2004, and 2003:

	2005	2004	2003
CSRS			
Employer	17.4	17.4	17.4*
Employee	7.0	7.0	7.0
Dual CSRS			
Employer	18.0	18.0	18.0
Employee	0.8	0.8	0.8
FERS			
Employer	11.2	10.7	10.7
Employee	0.8	0.8	0.8

*As of May 2003, P.L.108-18 changed our employer base contribution level for CSRS from 7.0%.

The number of employees enrolled in each of the retirement plans at the end of 2005, 2004, and 2003 is as follows:

	2005	2004	2003
CSRS	171,958	188,670	211,913
Dual CSRS	8,640	9,238	10,122
FERS	524,118	509,577	505,728

Expense Components

The following table lists the components of our total retirement expenses that are included in our compensation and benefits expense and related interest expense in the Statements of Operations for 2005, 2004 and 2003.

(Dollars in millions)

	2005	2004	2003
CSRS	$ 1,533	$ 1,641	$ 1,128
FERS	2,510	2,255	2,172
FERS Thrift Savings Plan	912	877	856
Dual CSRS	78	76	52
Social Security	1,750	1,610	1,544
Accrued Postal Supplemental Liability	27	12	9
Subtotal	$ 6,810	$ 6,471	$ 5,761
Interest expense on supplemental liability	263	103	116
Total retirement expense	**$ 7,073**	**$ 6,574**	**$ 5,877**

Employer cash contributions to retirement plans were $5,014 million in 2005, $4,827 million in 2004, and $4,031 million in 2003. These amounts do not include Social Security contributions and interest expense on deferred retirement liabilities.

Note 7 – The Postal Civil Service Retirement System Funding Reform Act of 2003 – P. L. 108-18

On April 23, 2003, the President signed into law the Postal Civil Service Retirement System Funding Reform Act of 2003 - P.L.108-18, which changed the way we contribute to the CSRS retirement plan. Although the law changed the funding of the plan, we determined that we are still a participant in a multi-employer pension plan. The parent-subsidiary relationship that we have as an "independent establishment" of the executive branch of the United States government allows for this accounting treatment under FAS 87. We cannot direct the costs, benefits, or funding requirements of the federally-sponsored plan.

We are required by P.L.108-18 to pay an additional annual amount, if necessary, each September, beginning in 2004, as determined by OPM. The additional amount is based on a calculation of any potential "supplemental liability," if one exists. The "supplemental liability" represents the excess of the actuarial present value of the future benefits liability over the actuarial present value of plan assets, future contributions, earnings, and other actuarial factors related to postal participants in the CSRS plan.

During 2005, OPM estimated the present value of benefits at $195.0 billion, contributions at $14.1 billion, and plan assets at $176.7 billion. This resulted in a "supplemental liability" of $4.2 billion as of September 2004, an increase of $700 million over the $3.5 billion "supplemental liability" as of September 30, 2003. This calculation assumed general salary increases of 4.0%, COLAs of 3.25%, and interest of 6.25% and is intended to provide for the liquidation of the "supplemental liability" over a 39-year period ending in September 30, 2043. Under the law OPM is not required to furnish the final actuarial calculation of the September 30, 2005, liability until June 30, 2006. OPM's calculation of the September 30, 2005 "supplemental liability" payment was $290 million, an increase of $50 million over the $240 million payment at September 30, 2004. OPM will recalculate the "supplemental liability," if any, on an annual basis. Each September 30, we will make any required payment resulting from this calculation.

Because the law went into effect in May 2003, we estimated the portion of the amount payable on September 30, 2004 attributable to 2003 and expensed that amount in 2003. This amounted to $125 million, of which $116 million was included as interest expense on our 2003 income statement. The 2004 portion of the "supplemental liability" was $115 million, of which $103 million is included as interest expense. In 2005 we included $263 million of the $290 million payment as interest expense.

Note 8 – Revenue Forgone

Our operating revenue includes accruals for revenue forgone. Revenue is forgone when Congress mandates that we provide free mail for designated mailers. Congress appropriates money to reimburse us for the revenue that we have forgone in providing these services. We have included as operating revenue the amounts appropriated by Congress for revenue forgone of $61 million for 2005, $36 million for 2004, and $31 million for 2003. We also included as operating revenue $48 million in 2005 for amounts due from Congress but not yet appropriated. Legislation enacted in each year delayed payment of the amount authorized until the first day of 2006, 2005, and 2004, respectively. Accordingly, we have recorded these amounts as a receivable at year end.

Notes to the financial statements

Under the Revenue Forgone Reform Act of 1993, Congress is required to reimburse us $29 million annually through 2035 (42 years). This reimbursement is for two purposes: services we performed in 1991, 1992, and 1993 for which we have not yet been paid; and for shortfalls in the reimbursement for the costs we incurred for processing and delivering certain nonprofit mail from 1994 through 1998.

The Revenue Forgone Reform Act of 1993 authorized a total of $1,218 million in payments. We calculated the present value of these future reimbursements, at 7% interest, to be approximately $390 million. We recognized the $390 million as revenue during fiscal years 1991 through 1998. The amount receivable as of the years ended September 30 was $360 million in 2005 and $364 million in 2004.

Note 9 – Commitments

At September 30, 2005 we estimate our financial commitment for approved capital projects in progress to be approximately $3,515 million.

Our total rental expense for the years ended September 30 is summarized as follows:

(Dollars in millions)

	2005	2004	2003
Non-cancelable real estate leases including related taxes	$ 892	$896	$ 923
Facilities leased from General Services Administration Subject to 120-day notice of cancellation	42	49	53
Equipment and other short-term rentals	209	213	201
Total	**$ 1,143**	**$1,158**	**$ 1,177**

At September 30, 2005 our future minimum lease payments for all non-cancelable leases are as follows:

(Dollars in millions)

	Operating	Capital
2006	$ 825	$ 100
2007	808	101
2008	777	100
2009	726	100
2010	669	100
After 2011	5,843	377
	$ 9,648	$ 878
Less: Interest		168
Total capital lease obligations		**710**
Less: Short-term portion of capital lease obligations		66
Long-term portion of capital lease obligations		**$ 644**

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 in the leases.

Capital leases included in buildings were $906 million in 2005 and $847 million in 2004. Total accumulated amortization is $318 million in 2005 and $259 million in 2004. Amortization expense for assets recorded under capital leases is included in depreciation expense which is included as "Other" in operating expenses in the statements of operations.

P.L.108-18 requires that we create an escrow, or restricted cash account of approximately $3.1 billion by September 30, 2006 in the event that Congress has not yet decided how to deploy the savings from the change in the retirement funding provisions.

Note 10 – Contingent Liabilities

Each quarter we review litigation pending against us. As a result of this review, we classify and adjust our contingencies for claims that we think it is probable that we will pay and for which we can reasonably estimate the amount of the unfavorable outcome.

These claims cover labor, equal employment opportunity, environmental issues, traffic accidents, injuries on postal properties, personal claims and property damages, and suits and claims arising from postal contracts. We also recognize the settlements of claims and lawsuits and revisions of prior estimates. Additionally, we evaluate the materiality of cases determined to have a reasonably possible chance of adverse outcome. Such cases are immaterial to our financial statements taken as a whole.

(Dollars in millions)

Contingent Liabilities	2005	2004
Labor cases	$ 308	$ 243
Equal Employment Opportunity cases	79	54
Tort cases	49	52
Environmental cases	25	25
Contractual cases	8	41
	$ 469	**$ 415**

Management and General Counsel believe that we have made adequate provision for the probable amounts due under the suits, claims and proceedings we have discussed here. Amounts we expect to pay in the next year are accrued in Commercial vendors and accrued expenses of current liabilities. The long term portion of the liability is accrued in Other Non-Current Liabilities of the balance sheets.

Note 11 – Emergency Preparedness Funding

In 2002, the United States was subjected to biological terrorism, utilizing the mail as the delivery medium. In response, we implemented process changes and technology applications to reduce the risk to both our employees and our customers. The President of the United States and Congress authorized funding of $762 million in 2002 to assist in paying for some of these safety measures, and to replace or repair postal facilities damaged or destroyed on September 11, 2001.

In 2003, the majority of our emergency preparedness expenses were for one-time activities, such as plant decontamination. We recognized these expenses as non-operating expenses and the corresponding revenue offset as non-operating revenue. Due to the ongoing nature of the remaining expenses, such as depreciation, supplies, and maintenance, beginning in 2004 we treated all emergency preparedness items as operating expenses and the associated revenue as operating revenue. As of September 30, 2004, all prior emergency preparedness appropriations have been fully expended or committed.

Not all our emergency preparedness expenditures are covered by the appropriations we received. The emergency preparedness expenses and capital equipment commitments for the years ended September 30 are as follows:

(Dollars in millions)

	2005	2004	2003
Operating expenses:			
Personnel costs	$ –	$ 9	$ 12
Non-Personnel Costs	79	123	–
Total operating expenses	**79**	**132**	**12**
Non-operating expenses	–	–	184
Total Expenses	**$ 79**	**$ 132**	**$ 196**
Capital Equipment commitments	**$ 313**	**$ 222**	**$ 189**

In December 2004, an appropriation by Congress of $503 million provided additional funds for Biohazard Detection Systems, Ventilation Filtration Systems, and an irradiation facility. Not all of these funds have been expended. We recognize the revenue when we depreciate the capital equipment purchased with the appropriation. The emergency preparedness appropriations revenues recognized during the years ended September 30 were $45 million in 2005, $92 million in 2004, and $177 million in 2003. We are funding other costs of mail security and employee protection such as maintenance and consumable supplies from Postal revenue and charging them as operating expense.

Appropriations that have not been recognized as revenue during the years ended September 30 were $772 million in 2005 and $314 million in 2004 with the current portion included in Prepaid box rent and other deferred revenue and the long term portion in Deferred revenue. We recorded the balance as a liability until spent. We defer as a non-current liability the amounts we spend on capital equipment and amortize them to offset the depreciation expense of the related equipment.

Operating statistics

(In millions of units indicated)

Class of Mail	2005	2004	2003	2002	2001
First-Class Mail					
Pieces, number	98,071.0	97,926.4	99,058.7	102,378.6	103,655.6
Weight, pounds	4,369.9	4,389.9	4,236.3	4,283.6	4,362.8
Revenue	$ 36,061.8	$ 36,376.8	$ 37,048.3	$ 36,483.2	$ 35,876.0
Priority Mail					
Pieces, number	887.5	848.6	859.6	998.2	1,117.8
Weight, pounds	1,690.7	1,623.3	1,622.9	1,875.1	2,149.7
Revenue	$ 4,633.6	$ 4,421.4	$ 4,494.3	$ 4,722.5	$ 4,916.4
Express Mail					
Pieces, number	55.5	54.1	55.8	61.3	69.4
Weight, pounds	51.7	50.6	53.2	59.1	72.1
Revenue	$ 872.3	$ 852.8	$ 888.1	$ 910.5	$ 995.7
Mailgrams					
Pieces, number	1.9	1.6	2.8	2.8	3.3
Revenue	$ 0.8	$ 0.7	$ 1.2	$ 1.4	$ 1.4
Periodicals					
Pieces, number	9,070.0	9,135.3	9,319.9	9,689.8	10,077.4
Weight, pounds	4,025.6	4,067.5	3,995.0	4,006.1	4,408.3
Revenue	$ 2,160.8	$ 2,191.8	$ 2,234.8	$ 2,164.9	$ 2,205.2
Standard Mail* **					
Pieces, number	100,942.1	95,563.5	90,492.2	87,230.6	89,938.4
Weight, pounds	11,656.5	11,148.3	10,827.6	10,315.5	10,822.2
Revenue	$ 18,953.5	$ 18,122.5	$ 17,231.3	$ 15,818.8	$ 15,704.9
Package Services					
Pieces, number	1,165.5	1,131.9	1,128.5	1,075.1	1,093.0
Weight, pounds	3,660.2	3,632.6	3,793.8	3,690.6	3,801.7
Revenue	$ 2,201.1	$ 2,206.9	$ 2,215.7	$ 2,080.1	$ 1,993.9
International Economy Mail					
Pieces, number	22.5	25.9	29.9	38.6	60.4
Weight, pounds	56.6	60.3	60.5	65.3	80.3
Revenue	$ 134.3	$ 145.2	$ 145.9	$ 150.4	$ 177.7
International Airmail* **					
Pieces, number	829.0	817.9	775.3	865.2	1,022.1
Weight, pounds	185.2	168.4	152.6	151.8	171.6
Revenue****	$ 1,630.5	$ 1,550.6	$ 1,441.0	$ 1,429.4	$ 1,554.0
U.S. Postal Service					
Pieces, number	621.3	529.3	391.6	424.9	380.6
Weight, pounds	110.7	105.4	80.1	87.5	82.3
Free Matter for the Blind					
Pieces, number	76.4	71.1	70.4	56.8	44.6
Weight, pounds	34.4	34.6	29.8	28.1	24.9
Totals*****					
Pieces, number	211,742.7	206,105.7	202,184.7	202,821.9	207,462.6
Weight, pounds	25,841.5	25,280.9	24,851.9	24,562.7	25,975.9
Revenue	$ 66,648.7	$ 65,868.7	$ 65,700.7	$ 63,761.1	$ 63,425.2

(In millions of units indicated)

Class of Mail	2005	2004	2003	2002	2001
Registered Mail*					
Number of Mail articles	7.7	7.4	8.2	9.1	11.4
Revenue	$ 77.2	$ 75.0	$ 82.1	$ 86.6	$ 98.4
Certified Mail*					
Number of Mail articles	261.1	273.7	271.4	283.5	269.0
Revenue	$ 600.6	$ 629.5	$ 624.2	$ 605.9	$ 494.8
Insurance*					
Number of articles	53.6	53.2	59.1	59.8	60.0
Revenue	$ 132.2	$ 127.8	$ 138.3	$ 135.2	$ 123.1
Delivery Receipt Services**					
Number of articles	953.8	840.6	748.8	535.5	421.1
Revenue	$ 569.2	$ 538.0	$ 503.1	$ 460.4	$ 370.8
Collect on Delivery					
Number of articles	1.5	1.9	1.9	2.3	2.7
Revenue	$ 9.3	$ 11.4	$ 11.1	$ 13.8	$ 15.3
Money Orders					
Number issued	181.0	188.0	202.5	218.0	227.2
Revenue	$ 208.2	$ 230.7	$ 230.7	$ 239.4	$ 225.4
Face value of issues (non-add)***	$ 28,723.0	$ 28,782.2	$ 29,151.7	$ 29,721.2	$ 30,770.3
Other					
Box rent revenue	$ 791.5	$ 779.9	$ 788.1	$ 750.6	$ 699.0
Stamped envelope and card revenue	$ 21.0	$ 21.9	$ 24.4	$ 29.3	$ 27.1
Other revenue, net	$ 740.3	$ 676.8	$ 395.8	$ 333.3	$ 287.5
Totals					
Special Services revenue	$ 3,149.5	$ 3,091.0	$ 2,797.8	$ 2,654.5	$ 2,341.4
Mail revenue	$ 66,648.7	$ 65,868.7	$ 65,700.7	$ 63,761.2	$ 63,425.2
Revenue forgone	$ 109.2	$ 36.3	$ 30.7	$ 47.6	$ 67.1
Operating revenue	**$ 69,907.4**	**$ 68,996.0**	**$ 68,529.2**	**$ 66,463.3**	**$ 65,833.7**

* Return receipts have been broken out from Registered, Certified Mail and insurance special service categories.
** Delivery Receipt Services contains Return Receipts, Return Receipts for Merchandise and Merchandise and Delivery Confirmation Service.
*** Certain reclassifications have been made to previously reported amounts.
**** Includes foreign postal transaction revenue.
***** Agency and franked mail are included in their classes of mail, when using official mail.

Some totals may not add exactly due to rounding.

Operating statistics

	2005	2004	2003	2002	2001
Headquarters and Related Employees*					
Headquarters ***	2,654	2,708	1,867	1,712	1,836
Headquarters-Field Support Units ** / ***	4,333	3,396	4,104	3,848	5,653
Inspection Service (field)	3,443	3,648	3,770	3,875	4,047
Inspector General	843	782	723	722	713
Total HQ and Related Employees	**11,273**	**10,534**	**10,464**	**10,157**	**12,249**
Field Career Employees*					
Area Offices **	1,420	2,196	2,205	2,107	1,377
Postmasters/Installation Heads	25,322	25,519	25,509	25,771	26,113
Supervisors/Managers	33,234	33,635	35,360	37,829	38,754
Prof. Admin. Tech. Personnel	8,945	9,168	9,436	9,661	9,764
Clerks	221,644	226,183	242,276	256,656	269,792
Nurses	167	167	171	173	180
Mail Handlers	56,028	54,769	56,776	59,259	60,102
City Delivery Carriers	228,278	228,140	229,404	233,639	240,295
Motor Vehicles Operators	8,689	8,628	8,778	9,092	9,325
Rural Delivery Carriers-Full Time	64,335	62,762	61,611	60,817	59,790
Bldg. & Equip. Maintenance Personnel	39,893	40,263	41,469	42,275	42,604
Vehicle Maintenance Personnel	5,488	5,521	5,576	5,513	5,558
Total Field Career Employees	**693,443**	**696,951**	**718,571**	**742,792**	**763,654**
Total Career Employees	**704,716**	**707,485**	**729,035**	**752,949**	**775,903**
Non-Career Employees*					
Casuals	19,182	20,529	17,373	19,065	30,317
Non-Bargaining Temporary	1,185	1,138	910	807	761
Rural Subs/RCA/RCR/AUX	57,411	56,403	56,451	56,474	58,134
PM Relief/Leave Replacements	12,046	12,157	12,161	12,234	12,313
Transitional Employees	8,460	9,884	11,025	12,847	13,577
Total Non-Career Employees	**98,284**	**100,111**	**97,920**	**101,427**	**115,102**
Total Employees	**803,000**	**807,596**	**826,955**	**854,376**	**891,005**

	2005	2004	2003	2002	2001
Post Offices, Stations and Branches					
Number of post offices	27,385	27,505	27,556	27,791	27,876
Classified stations and branches	5,622	5,623	5,796	5,900	5,835
Contract stations and branches	3,116	2,889	2,777	2,500	2,876
Community post offices	1,019	1,142	1,450	1,492	1,536
Total Offices, Stations and Branches	**37,142**	**37,159**	**37,579**	**37,683**	**38,123**
Residential Delivery Points ** / *******					
City	78,524,242	77,967,046	77,490,203	77,014,294	76,578,169
Rural	34,958,986	33,817,615	33,324,799	32,141,581	31,004,518
PO Box	15,614,801	15,634,610	15,730,694	15,772,964	15,818,625
Highway Contract	2,243,520	2,162,772	2,153,056	2,073,145	2,004,837
Total Residential Delivery Points	**131,341,549**	**129,582,043**	**128,698,752**	**127,001,984**	**125,406,149**
Business Delivery Points ** / *******					
City	7,280,384	7,185,300	7,208,608	7,197,207	7,183,431
Rural	1,230,645	1,172,499	1,192,144	1,132,049	1,071,201
PO Box	4,412,559	4,321,862	4,203,433	4,065,877	3,969,279
Highway Contract	61,228	58,084	58,339	55,362	52,247
Total Business Delivery Points	**12,984,816**	**12,737,745**	**12,662,524**	**12,450,495**	**12,276,158**
Total Delivery Points	**144,326,365**	**142,319,788**	**141,361,276**	**139,452,479**	**137,682,307**
Change in Delivery Points	2,006,577	958,512	1,908,797	1,770,172	1,736,256

* Complement data from On-Rolls and Paid Employee Statistics database as of end of September 2003–2005 and early September 2001–2002

** Beginning 2005 employees in the Sales organization were reported as Headquarter-Field Support Units instead of in the Area Offices

*** Beginning 2004 employees located outside the headquarters location, but performing headquarters functions are counted as headquarters employees.

**** The table above shows delivery growth of 958,512 in FY 2004. The absolute growth is 1,782,900 deliveries if FY 2003 were adjusted to reflect the current reporting procedure as implemented in FY 2004. For a more detailed discussion of the current reporting procedure, see the “Network Growth” section of the “Management Discussion and Analysis”.

***** FY 2003–2005 deliveries points are reported as of September 30th while FY 2001 – 2002 reflect deliveries as reported in early to mid–September.

Financial history summary

(Dollars in billions)

	2005	2004	2003
Statements of Operations			
Total revenue	$ 70.0	$ 69.0	$ 68.8
Total expense	68.6	65.9	64.9
Net income (loss)	**$ 1.4**	**$ 3.1**	**$ 3.9**
(Dollars in millions)			
Operating revenue	$ 69,798	$ 68,960	$ 68,498
Revenue forgone	109	36	31
Total operating revenue	69,907	68,996	68,529
Compensation and benefits	53,932	52,134	50,428
Other expenses	14,351	13,717	13,474
Total operating expenses	68,283	65,851	63,902
Income from operations	1,624	3,145	4,627
Interest and investment income	86	33	58
Interest expense on deferred retirement liabilities	(263)	(103)	(116)
Other Interest expense	(2)	(10)	(694)**
Emergency Preparedness, net	–	–	(7)
Net income (loss)	**$ 1,445**	**$ 3,065**	**$ 3,868**
Balance Sheets			
Assets			
Current Assets	$ 2,138	$ 2,121	$ 3,823
Property and equipment, deferred retirement costs and other assets	23,065	22,858	23,419
Total Assets	**$ 25,203**	**$ 24,979**	**$ 27,242**
Liabilities			
Current liabilities	$ 9,411	$ 11,070	$ 16,969
Other liabilities	10,416	9,978	9,407
Long-term debt	–	–	–
Equity	5,376	3,931	866
Total liabilities and net capital (deficiency)	**$ 25,203**	**$ 24,979**	**$ 27,242**
Changes in Net Capital (Deficiency)			
Beginning balances			
Capital contributions of the U.S. government	$ 3,034	$ 3,034	$ 3,034
Equity (Deficit) since reorganization	897	(2,168)	(6,036)
Total beginning balance net capital (deficiency)	3,931	866	(3,002)
Net income (loss)	1,445	3,065	3,868
Ending balance	**$ 5,376**	**$ 3,931**	**$ 866**

* Certain reclassifications have been made to previously reported amounts.
** Includes $360 million in debt repurchase expense

2002	2001	2000	1999*	1998*	1997*	1996*	1995*
$ 66.7	$ 65.9	$ 64.6	$ 62.8	$ 60.1	$ 58.3	$ 56.6	$ 54.5
67.4	67.6	64.8	62.4	59.5	57.0	55.0	52.7
$ (0.7)	**$ (1.7)**	**$ (0.2)**	**$ 0.4**	**$ 0.6**	**$ 1.3**	**$ 1.6**	**$ 1.8**
$ 66,415	$ 65,767	$ 64,476	$ 62,655	$ 60,005	$ 58,133	$ 56,309	$ 54,176
48	67	64	71	67	83	93	117
66,463	65,834	64,540	62,726	60,072	58,216	56,402	54,293
51,557	51,351	49,532	47,333	45,596	44,093	42,676	41,931
13,677	14,289	13,460	13,309	12,190	11,038	10,437	8,799
65,234	65,640	62,992	60,642	57,786	55,131	53,113	50,730
1,229	194	1,548	2,084	2,286	3,085	3,289	3,563
46	35	41	29	44	115	142	216
(1,601)	(1,603)	(1,568)	(1,592)	(1,613)	(1,629)	(1,496)	(1,443)
(340)	(306)	(220)	(158)	(167)	(307)	(368)	(566)
(10)	–	–	–	–	–	–	–
$ (676)	**$ (1,680)**	**$ (199)**	**$ 363**	**$ 550**	**$ 1,264**	**$ 1,567**	**$ 1,770**
$ 2,280	$ 1,933	$ 1,655	$ 1,296	$ 1,893	$ 1,736	$ 1,670	$ 2,975
56,735	57,158	56,628	54,713	53,015	51,675	50,157	46,146
$ 59,015	**$ 59,091**	**$ 58,283**	**$ 56,009**	**$ 54,908**	**$ 53,411**	**$ 51,827**	**$ 49,121**
$ 15,586	$ 17,457	$ 18,277	$ 15,436	$ 15,278	$ 14,107	$ 12,796	$ 11,499
39,131	38,209	38,150	37,466	37,652	37,439	37,746	34,794
7,300	5,751	2,502	3,554	2,788	3,225	3,909	7,019
(3,002)	(2,326)	(646)	(447)	(810)	(1,360)	(2,624)	(4,191)
$ 59,015	**$ 59,091**	**$ 58,283**	**$ 56,009**	**$ 54,908**	**$ 53,411**	**$ 51,827**	**$ 49,121**
$ 3,034	$ 3,034	$ 3,034	$ 3,034	$ 3,034	$ 3,034	$ 3,034	$ 3,034
(5,360)	(3,680)	(3,481)	(3,844)	(4,394)	(5,658)	(7,225)	(8,995)
(2,326)	(646)	(447)	(810)	(1,360)	(2,624)	(4,191)	(5,961)
(676)	(1,680)	(199)	363	550	1,264	1,567	1,770
$ (3,002)	**$ (2,326)**	**$ (646)**	**$ (447)**	**$ (810)**	**$ (1,360)**	**$ (2,624)**	**$ (4,191)**

Selected quarterly financial data

(Dollars in millions)
(unaudited)

2005	Quarter I	Quarter II	Quarter III	Quarter IV
Operating revenue	$ 18,786	$ 17,296	$ 16,847	$ 16,978
Total operating expenses	17,059	16,986	17,022	17,216
Income (loss) from operations	1,727	310	(175)	(238)
Other revenue (expense)	(45)	(35)	(65)	(34)
Net Income (loss)	**1,682**	**275**	**(240)**	**(272)**

2004	Quarter I	Quarter II	Quarter III	Quarter IV
Operating revenue	$ 18,209	$ 17,292	$ 16,591	$ 16,904
Total operating expenses	16,391	16,556	16,288	16,616
Income from operations	1,818	736	303	288
Other revenue (expense)	(1)	5	(44)	(40)
Net Income	**1,817**	**741**	**259**	**248**

Glossary

Accruals. Revenue and expenses that are recorded as they occur, even though they may not have actually been paid.

Amortize. To reduce the value of an asset through regular charges to income over time; or to write off expenses by prorating them over a period of time.

Appropriation. Public funds set aside by Congress for a specific purpose.

Capitalize. To treat an expenditure as an asset; or to compute the present value of a future payment that will be paid over a period of time.

Contribution. The difference between the revenue from a class of mail and that class's volume-variable costs. For example, if a class of mail has revenue of $1.5 billion and volume-variable costs of $1 billion, its contribution is $500 million, which means that this class of mail covers its costs and contributes $500 million to the common costs of all mail services.

Delivery Confirmation. A special service that provides the date of delivery or attempted delivery for Priority Mail and Standard Mail parcels, Bound Printed Matter and Library Mail.

Depreciate. To periodically reduce the estimated value of an asset over the course of its useful life.

Direct Mail. A form of advertising often employed by businesses to reach targeted groups of potential customers by mail.

Equity. The difference between the value of all assets less all liabilities.

Express Mail. The Postal Service's premium delivery service, providing guaranteed overnight delivery for documents and packages weighing up to 70 pounds. Both domestic and international services are offered.

First-Class Mail. A class of mail including letters, postcards and postal cards, all matter wholly or partially in writing or typewriting, and all matter sealed or otherwise closed against inspection.

Fixed Asset. Any tangible property such as buildings, machinery and equipment, furniture, and leasehold improvements.

Government Accountability Office (GAO). Investigative arm of legislative branch of federal government (Congress).

Generally Accepted Accounting Principles (GAAP). The rules and procedures of accepted accounting practice as defined by the Financial Accounting Standards Board.

Gross Domestic Product (GDP). The total market value of all the goods and services produced in one year in the United States.

Inspector General. The Inspector General is appointed by and reports directly to the Governors of the Postal Service and is independent of postal management. The Office of Inspector General (OIG) primarily investigates and evaluates programs and operations of the Postal Service to ensure the efficiency and integrity of the postal system.

Leasehold. An asset that gives the Postal Service the right to use property under a lease.

Liability. Any debt or obligation the Postal Service is bound to pay.

Operating Margin. A financial indication calculated by dividing income from operations by operating revenue.

Other Postemployment Benefits (OPEBS). OPEBS include retirement benefits other than pensions, such as retiree health benefits.

Periodicals. A class of mail, formerly called second-class mail, that consists of magazines, newspapers and other publications.

Postal Inspection Service. The investigative arm of the Postal Service responsible for investigating criminal acts involving the mails and misuse of the postal system.

Postal Rate Commission (PRC). An independent federal agency that makes recommendations concerning Postal Service requests for changes in postal rates and mail classifications.

Present Value. The value today of a future payment that is discounted at a stated rate of compound interest. For example, the present value of $100 that will be paid to the Postal Service 10 years from now is about $38.55, if we discount that $100 at a rate equal to 10% interest compounded annually.

Priority Mail. Priority Mail provides two- to three-day delivery service.

Processing and Distribution Center (P&DC). A large mail-sorting and dispatching plant that serves as a hub for mail originating from Post Offices, collection boxes and customer mailboxes, and large-volume mailers in a designated service area.

Receivable. Money that is owed to the Postal Service.

Recognize. To record in Postal Service accounts as income or expense.

Standard Mail. Bulk advertising mail formerly known as third-class mail.

U.S. Mail. Any mailable matter that is accepted for mail processing and delivery by the Postal Service.

Universal Service. The Postal Service's mandate and commitment to the nation to provide mail delivery service at uniform and reasonable rates to everyone, everywhere.

Year. As used in the financial section of this report, the Postal Service fiscal year, which is the 12-month period during which the Postal Service keeps accounts, beginning Oct. 1 and closing Sept. 30.

2006 Postage Stamps

- Love: True Blue
- Favorite Children's Book Animals
- 2006 Olympic Winter Games
- Hattie McDaniel (Black Heritage)
- Our Wedding
- Benjamin Franklin
- Art of Disney: Romance
- Sugar Ray Robinson
- AMBER Alert
- Katherine Anne Porter (Literary Arts)
- Wonders of America
- Washington 2006 World Philatelic Exhibition
- Samuel de Champlain Exploration
- Distinguished American Diplomats
- Legends of Hollywood: Judy Garland
- DC Comic Book Super Heroes
- Baseball Sluggers
- American Motorcycles
- Gee's Bend Quilts (American Treasures)
- Southern Florida Wetland (Nature of America)
- Holiday Snowflakes
- Christmas: Chacón Madonna & Child

Legends of Hollywood: Judy Garland
Format: 1 design; pane of 20

DC Comics Super Heroes
Format: pane of 20

Christmas: Chacón Madonna & Child
Format: 1 design; double sided booklet of 20

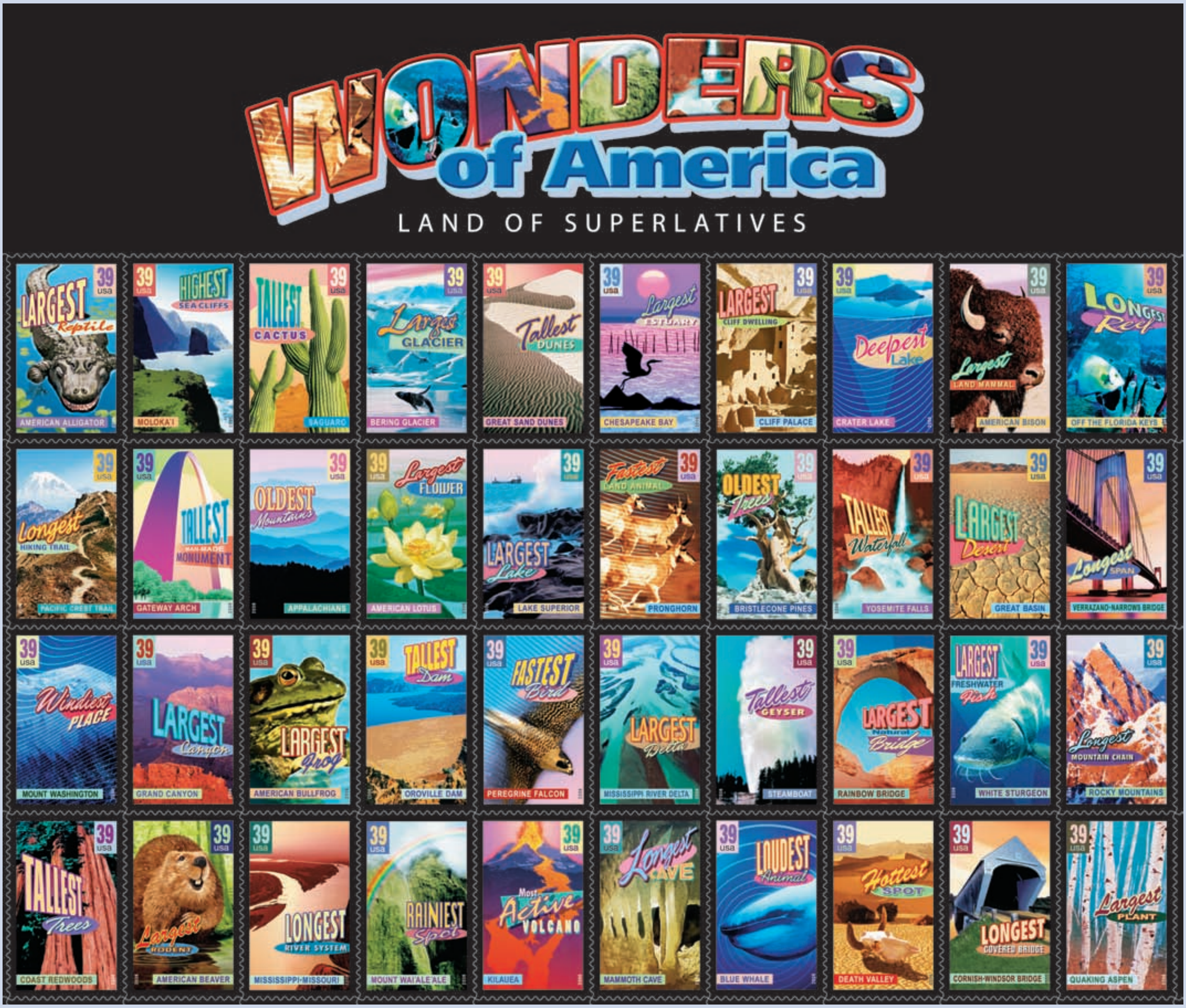
AMBER Alert
Format: 1 design; pane of 20

2006 Olympic Winter Games
Format: 1 design; pane of 20

Holiday Snowflakes
Format: 4 designs; multiple formats

Favorite Children's Book Animals
Format: 8 designs; pane of 16

Wonders of America
Format: pane of 40



American Motorcycles
Format: 4 designs; pane of 20

Art of Disney: Romance
Format: 4 designs; pane of 20

Benjamin Franklin
Format: 4 designs; pane of 20

Sugar Ray Robinson
Format: 1 design; pane of 20

Southern Florida Wetland (Nature of America)
Format: pane of 10 designs

Hattie McDaniel (Black Heritage)
Format: 1 design; pane of 20

Distinguished American Diplomats
Format: 6 designs; pane of 6

Our Wedding
Format: 2 designs; multiple formats

Baseball Sluggers
Format: 4 designs; pane of 20

Love: True Blue
Format: 1 design; pane of 20

Washington 2006 World Philatelic Exhibition
Format: souvenir sheet of 3

Samuel de Champlain Exploration
Format: 1 design; pane of 20

Gee's Bend Quilts (American Treasures)
Format: 10 designs; doublesided booklet of 20

Katherine Anne Porter (Literary Arts)
Format: 1 design; pane of 20

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