Financial Review
Part I

Item 1 – 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. We are governed by an eleven member Board of Governors. The Board is composed of nine Governors appointed by the President of the United States with the advice and consent of the Senate, the Postmaster General and the Deputy Postmaster General. Under the Postal Reorganization Act, we have a legal mandate to offer a "fundamental service" to the American people on a "fair and equitable basis". We fulfill this legal mandate to provide 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, 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 sold through our almost 37,000 Post Offices, stations, branches, contract postal units, our website www.usps.com and a large network of consignees. We deliver mail to more than 146 million city, rural, Post Office box and highway delivery points. We conduct our operations primarily in the domestic market, with international operations representing less than 3% of our total revenue.

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Over 85% of our career employees are covered by collective bargaining agreements. 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. Our management organizations include the National Association of Postal Supervisors, the National League of Postmasters and the National Association of Postmasters of the United States. We participate in federal employee benefit programs as required by statute, for retirement, health benefits and workers' compensation.

We are not subject to regulation by the Securities and Exchange Commission (SEC), nor are we required to produce, publish or file financial reports that comply with the SEC's rules and regulations on financial reporting. In preparing our financial reporting, we are guided by SEC reporting requirements to the extent deemed practical for a non-publicly traded, government-owned entity with a breakeven mandate. Additionally, we make disclosures not required by SEC reporting rules through the publication of certain reports that we either must make, or choose to make public. These additional disclosures on our organization and finances, including our Cost and Revenue Analysis reports, Integrated Financial Plan, and Revenue, Pieces, and Weight reports, may be found on our website, at www.usps.com/financials.

Segments
We operate in one segment throughout the United States its possessions, territories and internationally.

Strategy
The process of strategic planning in the Postal Service includes an ongoing assessment of the business environment, formulation of strategic goals, performance measures and targets, and tracking and integration of major strategic programs. Since its publication in April 2002, our Transformation Plan has provided focus and direction to all Postal Service business and operating activities. It is our principal planning tool for improving the value of mail and sustaining a financially stable enterprise that meet the nation's needs for affordable and reliable universal service. The plan defines our vision and establishes our strategic goals in the areas of service, revenue, cost savings and human capital.

Transformation assures continuity between our longer-term direction and our near-term corporate objectives, which are published each year as our Annual Performance Plan in compliance with the requirements of the Government Performance and Results Act. It helps bridge our internal priorities and operating activities with events and conditions in our larger business environment.
Transformation in the Postal Service is designed to be dynamic and adaptable. For that reason, the plan was

updated at the start of this fiscal year, with the publication of our new *Strategic Transformation Plan, 2006-2010.* This new plan builds on our successes since 2002, and commits us to new advances in service, customer convenience, productivity and employee engagement. We will maintain a tight focus on our core services to ensure that universal and affordable postal services continue to promote communication, reach key audiences and help bind America together. We are committed to continue taking an average of $1 billion out of our cost base each year through 2010 while employing equally aggressive measures to grow the business.

During 2006, significant actions were taken on all major strategies described in the plan. These included a number of large-scale efforts designed to bring about fundamental long-term change. Our rate case filing was developed to remedy longstanding cost-coverage issues and to better align mail processing and delivery operations. We continued to enhance our products and add convenient new options for accessing our services. Examples include Premium Forwarding Service, online customs forms and the new Priority Mail Flat-Rate shoebox, which helped contribute to an increase in revenue.

We launched our visibility strategy with the introduction of the 4-State Customer Barcode at the National Postal Forum. Ultimately, this strategy will allow for tracking individual mail pieces, using a new barcode, supporting systems and processes, with the potential to dramatically increase the value of mail for customers and improve service and operating efficiency. We also implemented multiple enhancements to the PostalOne system, which forms the foundation for the automation of commercial mail acceptance.

In our operations, we established broad new internal processes for quality control and timely cross-functional hand-offs. We began live tests with our Flats Sequencing System, the next step in postal mail processing automation. A filing was submitted to the PRC for an advisory opinion on our delivery network redesign. This will support the need for an evolutionary network design. We also started multiple efforts to improve the accuracy and quality of mailing addresses.

The full text of our Strategic Transformation Plan 2006-2010 is available at www.usps.com.

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:

FIRST-CLASS MAIL – Includes postcards, letters, or any other advertisement or merchandise up to 13 ounces. 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 non-guaranteed delivery service is typically used to send documents, gifts and merchandise.

EXPRESS MAIL - This overnight money-back guaranteed service includes tracking, proof of delivery and insurance up to $100. Delivery is offered to most destinations and is available 365 days a year with no extra charge for weekend and holiday delivery.

PERIODICALS - Offered for newspaper, magazine and newsletter distribution and requires prior authorization by the Postal Service.

STANDARD MAIL - Is offered for any item, including advertisements and merchandise weighing less than 16 ounces that are not required to be sent using First-Class Mail. Standard Mail is typically used for bulk advertising to multiple delivery addresses. Content restrictions apply for authorized nonprofit mailers.

PACKAGE SERVICES - Are offered for any merchandise or printed matter weighing up to 70 pounds. These services include Parcel Post, Bound Printed Matter, Library Mail and Media Mail.

SPECIAL SERVICES - Offer a variety of enhancements that add value to mail by providing added security, proof of delivery or loss recovery. These services include: Certified Mail, Registered Mail, Delivery Confirmation, Signature Confirmation and insurance up to $1,000.

MONEY ORDERS - Are offered as a safe, convenient and economical alternative to sending cash through the mail. They can be purchased at any Post Office as well as from any rural route carrier. Postal Money Orders are available for any amount up to $1,000 and are restricted to 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 PRC reviews our proposals to establish and change domestic mail rates, fees and mail classifications. The PRC holds public hearings and issues recommended decisions to the Board of Governors of the Postal Service, who approve, reject, or, in some cases modify the PRC'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 January 8, 2006 the Postal Service implemented an average 5.4% postage rate increase across all rate classifications in order to generate revenues to partially fund the escrow requirements set forth in the Postal Civil Service Retirement System Funding Reform Act of 2003, Public Law 108-18 (P.L. 108-18).

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

In other rate and classification activity, on April 2, 2006, the Postal Service implemented a one-year extension of the provisional Repositionable Notes service. On June 1, 2006, a baseline Negotiated Service Agreement (NSA) with Bookspan was implemented. This is the first NSA involving Standard Mail. On September 13, 2006, a one-year extension of the existing NSA with Capital One was implemented, as was a minor classification change involving the eligibility criteria for Periodical rates.

Information on PRC recommended decisions and pending dockets can be obtained at the PRC website 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 affect the way businesses and consumers interact.

Of greatest impact on us are electronic alternatives to correspondence and transactions, particularly for First-Class Mail items such as business correspondence, bills, statements and customer payments. First-Class Mail volume has already been affected by the Internet, telephone, fax machine and other electronic communications. The Internet and electronic commerce also have a positive impact on our business by stimulating new uses of postal services, such as package delivery and targeted ad mail.

Major corporations now dominate parcel and express markets. Under the current regulatory structure, competitors have far more pricing flexibility to quickly respond to changes in market conditions and to target individual customers for special incentives.

The competitive landscape for postal services is becoming more global. Foreign postal operators are moving outside of their geographic borders and expanding beyond their traditional postal services into offering express delivery, logistics, financial and electronic services. More than a dozen mainly European posts have set up operations in the United States at more than 3,500 locations nationwide. Retail locations, sales offices and full-scale offices of exchange are offering mailing services, parcel, logistics and financial services to the American market. Despite our competitive global products, we have a disadvantage because our international air transportation rates are set by the U.S. government and are not subject to more favorable market-driven rates available to foreign posts. This has contributed to an increase in outbound market share to our foreign competitors.

Intellectual Property

We own 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 holiday mailing season, and lowest during the summer, our fourth quarter.

Customers

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

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 for design, development, and testing of postal equipment and operating systems. While research and development activities are important to our business, these expenditures are not material. Our research and development expenses were $41 million for 2006, $41 million for 2005 and $51 million for 2004. 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 terrorism utilizing the mail as the delivery medium for biological attack, the Board of Governors approved the Biohazard Detection System and the Ventilation Filtration System projects. These projects, which are continuing to be deployed, provide a level of protection to our employees and customers from potential biological contamination.

Number of Employees

At September 30, 2006, we had 696,138 career employees, substantially all of whom resided in the United States. We also had 100,061 non-career employees.

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

We make available, free of charge, copies of our annual report, as soon as reasonably practicable after it is produced. Requests for copies should be sent to:

United States Postal Service
Public Affairs and Communications
475 L’Enfant Plaza, SW
Washington, DC 20260-3100.

Item 2 – Properties

Real Estate

Our facilities range in size from fifty square feet to 34 acres under one roof, and support retail, delivery, mail processing, maintenance, administrative and support activities.

Real Estate Inventory	2006	2005
(Actual numbers)		
Leased Facilities	25,567	25,772
Owned Facilities	8,437	8,399
GSA / Other Government Facilities	408	417
Total Real Estate Inventory	34,412	34,588
Annual Rent paid to lessors (Dollars in millions)	$ 1,002	$ 934

The majority of our small and medium sized facilities support the retail and delivery operations located in virtually every community across this country. Our retail and delivery operations are supported by 32,875 leased or owned facilities. We also provide retail services through 3,951 Contract Postal Units and Community Post Offices where the facility is owned and maintained by the contractor.

Retail and Delivery Facilities	2006	2005
(Actual numbers)		
Post Offices	27,318	27,385
Classified Branches	1,522	1,540
Classified Stations	3,457	3,498
Carrier Annexes	578	584
Contract Postal Units	3,014	3,116
Community Post Offices	937	1,019
Total Retail and Delivery Facilities	36,826	37,142

Our larger facilities typically support mail processing operations which move millions of pieces of mail across the country on a daily basis.

Processing Facilities	2006	2005
(Actual numbers)		
Processing and Distribution Centers	269	269
Customer Service Facilities	195	195
Bulk Mail Centers	21	21
Priority Mail Processing Centers	11	11
Annexes	66	66
Surface Transfer Centers	17	14
Airmail Processing Centers	77	79
Remote Encoding Centers	12	15
International Service Centers	5	5
Total Processing Facilities	673	675

We also have approximately 1,000 other types of facilities including administrative, vehicle maintenance and miscellaneous support facilities.

Vehicles

We have one of the largest vehicle fleets in the United States, which includes an extensive fleet of alternative fuel vehicles.

Vehicle Inventory	2006	2005
(Actual numbers)		
Delivery and Collection Vehicles (1/2 - 2 ton)	190,932	188,673
Mail Transport Vehicles (Tractors and Trailers)	7,484	6,909
Administrative Vehicles and Other Vehicles	6,296	6,533
Service Vehicles (Maintenance)	5,623	5,688
Inspection Service and Law Enforcement Vehicles	3,212	3,293
Mail Transport Vehicles (3 - 9 ton)	2,457	3,050
Total Vehicles	216,004	214,146

Item 3 – Legal proceedings

We are subject to various claims and liabilities that arise in the normal course of postal operations. These claims generally relate to 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, 2006, the estimated impact of those claims we think it is probable we will pay. See Note 8, *Contingent liabilities* in Notes to the Financial Statements for additional information.

Item 4 – Submission of matters to a vote of security holders

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

Financial Review
Part II

Item 5 – Market for registrant's common equity and related stockholder matters

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

Item 6 – Selected financial information

See the *Financial History Summary* and *Selected Quarterly Financial Data* sections of this report.

Cautionary Statements

Statements contained in Management's Discussion and Analysis represent our best estimate of the trends we know about, the trends we anticipate and the trends we think are relevant to our future operations. However, actual results may be different from our estimates. Certain forward-looking statements are included in this report and use such words as "may," "will," "expect," "believe," "plan," or other similar terminology. These statements reflect our current expectations regarding future events and operating performance 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

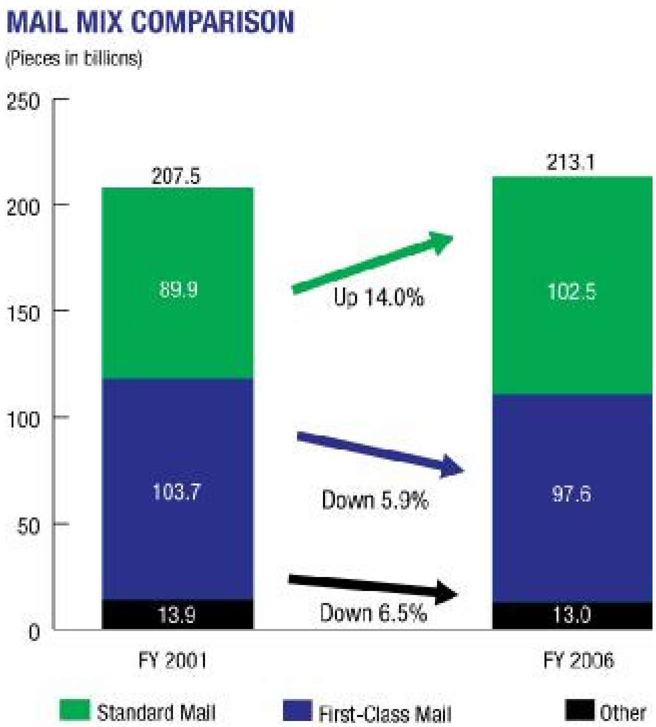
Revenue for 2006 was $72,817 million, an increase of $2,824 million over last year. This was primarily due to an increase in average postage rates of 5.4% across all rate classifications implemented on January 8, 2006. Total volume in 2006 of 213.1 billion pieces was 1.4 billion pieces or 0.7% above last year. Standard Mail had the largest volume increase of all postal products with 1.5 billion additional pieces or 1.5% over 2005. Total volume declined in the first quarter by 1.5% compared to the first quarter of 2005, but grew an average of 2.3% in quarters two and three when compared to the same period last year. In the fourth quarter, volume declined 0.1% compared to quarter four of 2005, or 64 million pieces as a result of the slowing economy.

Mail Volume by Type	2006	2005	2004
(Pieces in millions)			
Standard Mail	102,460	100,942	95,564
First-Class Mail	97,617	98,071	97,926
Periodicals	9,023	9,070	9,135
Package Services	1,175	1,166	1,132
Priority Mail	924	887	849
Express Mail	56	55	54
International	793	852	844
Other *	1,090	700	602
Total Mail Volume by Type	213,138	211,743	206,106

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

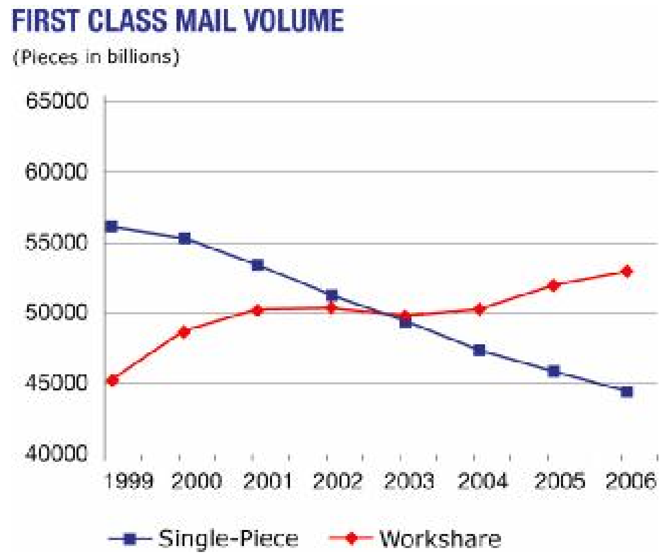
Standard Mail volume exceeded First-Class Mail volume for the second consecutive year. Standard Mail's volume growth in 2006 was the slowest since 2002, when advertising expenditures declined throughout the economy as a result of a recession.

The softness in Standard Mail volume growth is attributable to lackluster growth in Standard Regular Mail of 1.5% as well as a decline of 13.4% in Nonprofit Enhanced Carrier Route Mail. Despite these weaknesses, Standard Mail continues to hold its ground in the advertising market by virtue of its two dominant characteristics; it can be targeted to specific audiences, and its effectiveness can be measured by the customer.



As shown on the chart above the change in mail mix has a large impact on our revenue. If the mail mix had remained the way it was in 2001 we would have had an estimated additional $2.5 billion in revenue in 2006.

First-Class Mail volume, our largest mail class until 2005, decreased slightly in 2006, declining for the third time in the last four years. An increase of 1,075 million pieces or 2.1% in workshare First-Class letters partially offset the continuing decline in single-piece volume, which was down 1,529 million pieces or 3.3%. The long-term continued decline in single-piece volume reflects the impact of electronic diversion as businesses, nonprofit organizations, governments, and households increasingly automate transactions and divert correspondence to the Internet. Consolidation in the pre-bar-coded mailer market suggests that some of the single-piece First-Class Mail may be migrating to workshare First-Class Mail. Although workshare First-Class Mail volume increased in 2006, the growth rate was less than half the growth rate in 2005. Workshare letters are also affected by electronic diversion, but to a lesser extent. A slowdown in credit card solicitations may have put added downward pressure on workshare letter growth.



For the second year in a row, Priority Mail volume increased. The 4.1% growth rate was especially encouraging in light of the January rate increase since demand for Priority Mail is relatively price sensitive. Four factors continue to drive this performance. First, we have worked to consistently improve Priority Mail service performance. Second, Priority Mail is increasingly easy to use. Customers can purchase postage and print mailing labels with free delivery confirmation through Click-N-Ship at http://www.usps.com/onlinepostage/ or on commercial websites. Carrier pickup saves customers a trip to the Post Office and our flat rate envelope and flat rate boxes simplify Priority Mail use further. Third, prior to the January 8, 2006 rate increase, Priority Mail rates had not changed since June 2002, while our competitors' published rates have increased almost annually during the same period. Finally, the increase in our competitors' surcharges for fuel, residential delivery, and delivery in rural areas make Priority Mail a cost effective choice.

We continue to develop new Priority Mail products such as Priority Flat Rate Boxes which allow customers to send Priority Mail at a flat rate price of $8.10 regardless of the weight of the box. Originally launched in November 2004 with two different shaped boxes, in 2006 we added a flat rate shoe box.

Express Mail volume increased 475,000 pieces over 2005, and like Priority Mail, Express Mail had benefited from continued rate stability, and the impact of surcharges imposed by private sector competitors, as well as website access on www.usps.com. This is the second consecutive year of volume increases for Express Mail after four years of declines.

Package Services volume increased 9 million pieces, or 0.8% over 2005. A volume increase in Bound Printed Matter of 6% or 35 million pieces was partially offset by declines of 6.5% or 25 million pieces in Parcel Post and Media Mail of 2 million pieces or 1.2%. The Parcel Select component of Parcel Post was adversely affected by three major parcel consolidators which ceased operations in 2006.

Periodical Mail volume declined 0.5% compared to 2005 continuing a long-term trend, as businesses and consumers utilize less hard-copy material and increasingly rely on the Internet as a substitute for hardcopy publication of news, information and entertainment.

Revenue	2006	2005	2004
(Dollars in millions)			
First-Class Mail	$ 37,039	$ 36,062	$ 36,377
Standard Mail	19,877	18,953	18,123
Priority Mail	5,042	4,634	4,421
Package Services	2,259	2,201	2,207
Periodicals	2,215	2,161	2,192
Express Mail	918	872	853
International	1,794	1,765	1,696
Other *	3,673	3,345	3,160
Total Revenue	$ 72,817	$ 69,993	$ 69,029

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

Operating Expenses

Operating expenses are comprised of Compensation and Benefits, Transportation, Supplies and Services, Depreciation and Amortization and Other Expenses.

In 2006 operating expenses of $71,684 million were $3,401 million or 5.0% more than 2005. The increase was driven primarily by a 4.4% increase in compensation and benefits, and an 11.2% increase in transportation expenses. Increasing 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 by contractual pay increases and retirement and health benefits costs. These same factors drove the $2,432 million increase in operating expenses in 2005, compared to 2004.

Operating Expenses	2006	2005	2004
(Dollars in millions)			
Compensation and Benefits *	$ 56,281	$ 53,932	$ 52,134
Transportation	6,045	5,437	4,969
Supplies and Services * *	2,643	2,557	2,423
Depreciation and Amortization	2,149	2,089	2,145
Other Expenses * *	4,566	4,268	4,180
Total Operating Expenses	$ 71,684	$ 68,283	$ 65,851

* Does not include interest on deferred retirement obligations. Interest is not considered an operating expense on the financial statements.

* * Presentation change moved advertising expense from other expense to supplies and services in 2005 and 2004.

Compensation and Benefits

Personnel compensation and benefits, including interest on deferred retirement obligations, comprised 78.6% of our total expenses. These costs grew $2,317 million or 4.3% in 2006. This year's growth was due primarily to contractual pay increases, COLAs and health benefits payments for current and retired employees. Our 2006 average hourly labor cost increased by 4.7%, and our 2006 health benefits expense for current employees and retirees increased by $387 million to $6,982 million. This was 9.7% of total expenses. Workers' compensation increased $441 million over 2005. This accounted for almost 20% of the total personnel compensation and benefits growth in 2006. See *Workers' Compensation* in this section for additional information.

The 2005 increase of $1,958 million in compensation and benefits expenses was driven by the same factors as the 2006 increase, although COLAs were smaller in 2005. Average hourly labor rates in 2005 increased by 2.5% over 2004. In 2004 the increase in compensation and benefits was partially offset by a $401 million decrease in workers compensation expenses.

Compensation and Benefits Expense	2006	2005	2004
(Dollars in millions)			
Compensation	$ 40,570	$ 39,299	$ 37,876
Retirement	7,237	7,073	6,574
Health Benefits	5,345	5,100	4,845
Retiree Health Benefits	1,637	1,495	1,313
Workers' Compensation	1,279	838	1,239
Other	444	390	390
Total *	$ 56,512	$ 54,195	$ 52,237

* Equals compensation and benefits plus interest on deferred retirement.

In addition to labor and benefits rates, workhours are a major driver of our compensation and benefits expense. This year's growth in costs was slightly tempered by a reduction of almost five million workhours or 0.3%. The 2006 workhour reduction is the sixth year out of seven in which workhours have been reduced. In 2006, mail processing, customer service and city delivery workhours decreased 7 million compared to 2005, while rural delivery experienced an almost 7 million increase in workhours. The rural delivery workhour growth was driven by the addition of over one million new delivery points and by increased mail volume.

Since 2000, we have cumulatively eliminated 867 million workhours, which has been the single largest contributor to the ongoing achievement of our savings targets.

Workhours by Function	2006	2005	2004
(Workhours in thousands)			
City Delivery	468,918	471,071	464,683
Mail Processing	332,269	336,210	336,737
Customer Services & Retail *	246,538	247,512	248,097
Rural Delivery	186,164	179,549	171,628
Plant & Equipment Maintenance	81,366	80,867	81,302
Vehicle Services	32,116	31,880	31,947
Operations Support	9,882	9,606	9,077
Limited Duty & Rehabilitation	375	3,604	6,356
Postmasters, Managers, Supervisors, Administration, and Other: *	101,101	102,954	102,494
Total Workhours	1,458,729	1,463,253	1,452,321

* Due to a change in calculating customer service hours we have adjusted hours to be presented on a comparable basis. Total workhours are not changed.

Over 85% of our career employees are covered by collective bargaining agreements. Our major collective bargaining agreements all expire on 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

Our employees participate in one of three retirement programs of the U.S. government 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). See Note 10, *Retirement programs* in Notes to the Financial Statements for additional information.

The programs are administered by the Office of Personnel Management (OPM). The expenses of all of our retirement programs are included in compensation and benefits expense.

The implementation of P.L.108-18, did not alter the fact that retirement expenses remain a significant portion of our total expenses. Retirement expenses for current employees, including interest on deferred retirement obligations, represented 10.1% of our total expenses in 2006 and 10.3% in 2005.

As described in the Notes to the Financial Statements, Note 2, *Summary of significant accounting policies,* we account for our participation in the retirement programs of the U.S. Government under multi-employer plan accounting rules, in accordance with Financial Accounting Standard Board Statement 87, *Employers' Accounting for Pension Costs*. Although the Civil Service Retirement and Disability Fund (CSRDF) is a single fund and does not maintain separate accounts for individual agencies, the following table provides OPM's estimation of the funding status of the CSRS and FERS programs for Postal Service participants as of September 30, 2005. This is the most recent data provided by OPM.

Present Value Analysis of Retirement Programs			
	CSRS	FERS	Total
(Dollars in billions as of 09/30/05)			
Present Value of Benefits	$ 196.9	81.2	$ 278.1
Present Value of Contributions *	$ 12.3	36.6	$ 48.9
Current Fund Balance	$ 180.9	52.9	$ 233.8
Surplus (Deficit)	$ (3.7)	8.3	$ 4.6

* Expected employer and employee contributions

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 CSRS obligations and altered the related schedules for our payments to the CSRDF. The law was enacted in response to a November 2002 review of funding estimates, including Postal Service payments 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 the current law through 2002. P.L.108-18 required as of May 2003, that we begin to fund our obligations to the CSRDF based on dynamic assumptions. The dynamic funding assumptions include the full value of future benefits to our employees related to military or volunteer service when calculating the actuarial present value of future benefits by OPM. Under the previously existing law, military and voluntary service costs were funded by the United States Treasury Department. As calculated by OPM, the recognition of military service credit effectively transferred $27 billion in obligations from U.S. taxpayers to our ratepayers. This assumption of funding responsibility by the Postal Service 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. See Note 10, *Retirement programs* in Notes to the Financial Statements for additional information.

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 2004, as required by law, 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 further reduced our debt by an additional $2.8 billion, for a total debt reduction of $5.5 billion. 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.

Pending future legislation, any "savings" after 2005 must be placed in escrow. To partially fund the 2006 escrow requirement, we raised postage rates an average of 5.4% across all rate classifications on January 8, 2006. On September 30, 2006 we placed $2,958 million into a restricted cash account.

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 after retirement. We account for our employee and retiree health benefit costs as an expense in the period our contribution is due and payable to FEHBP using multi-employer plan accounting rules in accordance with Financial Accounting Standards Board Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.*

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 2006, health benefit expenses for active employees were $5,345 million, an increase of $245 million over 2005. This was 7.4% of our total expenses. The 2005 expense of $5,100 million was 7.4% of our total expenses and increased by $255 million over 2004 when employee health benefits were 7.3% of our total expense.

Retiree health benefit costs, which are 2.3% of our total expenses, were $1,637 million in 2006 up from $1,495 million in 2005 and $1,313 million in 2004. This cost has risen steadily over the last three years, and has more than 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 9.5% or $142 million in 2006 and 13.9% or $182 million in 2005.

In September 2006, OPM announced a 1.8% average increase in health benefit premiums, to take effect in January 2007, following a 6.6% increase in January 2006. A major factor in the lower health benefit premiums is a one time change by OPM which released a health benefits fund surplus to lower the cost. As of the end of 2006, there were approximately 448,000 Postal Service annuitants and survivors compared to 444,000 in 2005 and 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 requires us to account for this expense using multi-employer plan accounting rules. If we were not a participant in the federal government plan, we would be required to record and disclose our obligation for future health benefit obligations. 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, 2006 data, we estimate, that if we sponsored our own plan at similar costs and benefits to the federal plans, the 2006 present value of future premium payments to be between $50 billion and $58 billion. Based on September 30, 2005 data, we estimated the 2005 value of future payments to be between $50 billion and $59 billion. In both cases, the range in the estimate exists only because long-term medical inflation assumptions differed by 1%.

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 from 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 2006, we estimate our total liability for future workers' compensation costs at $7,863 million, an increase of $342 million or 4.5% from 2005. In 2005 our liability declined $58 million or 0.8% from 2004.

In 2006 we experienced a 2.3% decrease in the number of paid medical claims and a 1.7% decrease in the number of paid compensation claims. Although the number of paid claims decreased, the actual cost of claims increased $45 million over 2005. A factor in this increase was the 3.5% January 2006 COLA which raised the payments to all compensation claimants on the rolls. The $45 million increase in the cost of claims also was the driver behind the $342 million increase in our total liability. 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. The total expenditure in 2005 was $12 million lower than 2004.

The lower number of claims 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 809 successful outplacements and rehabilitations in our fourth year of a five year program to outplace 1,000 employees from the workers' compensation roles. This program has long-term impacts to the cost of workers' compensation by reducing the base costs. Finally, OWCP has instituted a more rigorous review of medical bills to lower costs. See Note 11, *Workers compensation* in the Notes to the Financial Statements for additional information.

Transportation Expenses

Transportation expenses for 2006 were $6,045 million, an increase of $608 million or 11.2% over 2005 expenses. A large part of this increase was due to increased fuel expenses of $307 million. 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. Transportation expenses in 2005 were $5,437 million, an increase of $468 million over 2004 and were driven by many of the same factors mentioned above.

Transportation Expense (Dollars in millions)	2006	2005	2004
Air Transportation	$ 2,771	$ 2,445	$ 2,185
Highway Transportation	2,977	2,658	2,423
Other Transportation	297	334	361
Total Transportation Expense	$ 6,045	$ 5,437	$ 4,969

AIR TRANSPORTATION

Air transportation expenses for 2006 were $2,771 million, an increase of $326 million over 2005. 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 2006, the index by which jet fuel costs are adjusted increased 45.4%, resulting in an increase in fuel costs of approximately $130 million. Increased mail volume added an additional $33 million in fuel costs and more air mail volume increased costs by $51 million. Contractual rate increases contributed an additional $77 million in air transportation costs.

Air transportation expenses for 2005 were $2,445 million, an increase of $260 million over 2004. As with the current year, 2005 was impacted by increasing fuel cost and mail volume. Jet fuel costs attributed to fuel price increases added almost $83 million and extra fuel cost from added mail volume accounted for $26 million.

HIGHWAY TRANSPORTATION

Highway transportation expenses increased by $319 million in 2006 as fuel prices and volume increased. Diesel fuel used by our highway contract routes increased $144 million, while increased volume and usage of highway transportation added another $102 million in expense over 2005 totals. Contractual rate increases accounted for an additional $73 million.

In 2005, our highway transportation expenses increased by $235 million mainly driven by fuel prices and volume increases. Diesel fuel costs rose by $102 million. Contractual rate increases accounted for an additional $79 million while increased volume and usage of highway transportation added another $54 million in expense over 2004.

OTHER TRANSPORTATION

Other transportation expenses decreased $37 million in 2006. International mail transportation costs decreased $47 million. This decline was partially offset by increases in rail transportation and water transportation of $10 million.

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

Aviation Security

On October 4, 2006, the President signed into law the FY 2007 Homeland Security Appropriations Act, P.L.109-295. The Act requires the Secretary of Homeland Security to research, develop and procure new technology for screening cargo on passenger aircraft at the earliest date practicable. It also requires the Transportation Security Administration (TSA) to utilize existing checked baggage explosive detection equipment and screeners to screen cargo carried on passenger aircraft to the extent practicable until the new technologies are available. It is unclear whether the TSA will use such equipment to increase mail screening in order to meet the requirement. The law also requires the TSA to report air cargo inspection statistics on a quarterly basis, including the total number of packages. The Postal Service will continue to monitor and communicate with TSA as it implements these legislative mandates. Mail on commercial aircraft is considered air cargo for these purposes.

Supplies and Services

Supplies and services expenses of $2,643 million increased $86 million in 2006. Expenses for professional, consulting and other services increased approximately $57 million compared to the same period last year. This increase was largely due to increased credit and debit card transaction and processing fees of $19 million. Supplies expense increased approximately $16 million and equipment rental and repair charges increased $19 million. These were offset by a decline in advertising expenses of $5 million.

In 2005, supplies and services expense charges were $2,557 million, an increase of $134 million over 2004. This was attributed to increases of $103 million in supplies for items such as mail transportation equipment and advertising increases of $35 million. Offsetting some of the increase was a reduction in equipment repairs and rental expenses, which declined by $39 million in 2005.

Depreciation and Amortization

Depreciation and amortization expenses of $2,149 million in 2006 were $60 million or 2.9% more than last year. This increase is primarily due to increased deployment of equipment purchased under the emergency preparedness program and new mail processing equipment. Depreciation expenses of $2,089 million in 2005 decreased $56 million or 2.6% from 2004. See Note 13, *Emergency preparedness funding* in the notes to the financial statements for additional information.

Other Expenses

Other expenses were $4,566 million in 2006, an increase of $298 million or 7.0%. The major components and costs included in this category are rent and utilities of $1,721 million, vehicle maintenance services of $1,194 million, information technology of $395 million, communications of $254 million, travel and training of $236 million and facility repairs and alterations of $224 million. In 2005, other expenses increased by $88 million over 2004.

Rent and utilities were up $132 million or 8.3% over 2005, driven by a $60 million increase in electricity cost. Vehicle maintenance services increased by $159 million, or 15.3%, driven by an aging fleet and increasing fuel prices. The same was true in 2005 when the increase was $114 million or 12.3% over 2004. Communications expense was virtually unchanged from 2005. In 2005 communication costs increased by $35 million or 16.3%. This was mainly from upgrading the communication lines in many of our offices. Information technology costs also remained relatively flat with a small decline of $3 million in 2006. In 2005 these costs decreased $78 million or 16.4% from 2004. This reflected the downward price trend in this industry and favorable negotiations on software maintenance and licensing agreements. Facility maintenance expenses were virtually unchanged in 2006 from 2005 while declining $21 million or 8.6% from 2004 to 2005 as repair projects declined that year.

In 2006 our provision for contingent liabilities decreased $27 million. In 2005, we significantly increased our provision due to an unfavorable settlement of three labor-related arbitration cases. These cases contributed approximately $115 million to the increase in other expenses.

Service and Performance

Management monitors several key statistics to determine performance against our service standards. The major indicators we monitor are the External First-Class (EXFC) on-time mail delivery scores and the Customer Satisfaction Measurement (CSM) scores.

EXFC is an independently administered system that provides an external measure of delivery performance from collection box to mailbox. Although not a system-wide measurement of all First-Class Mail performance, EXFC continuously tests a panel of 463 3-digit ZIP Code areas selected on the basis of geographic area and volume density, thereby providing a measure of service performance from the customer's point of view. Results of these measures for the last four quarters are listed below.

Service Performance Scores	Quarter 1	Quarter 2	Quarter 3	Quarter 4
(EXFC Percentage delivered on time)				
Overnight Delivery	94	95	95	95
2-Day Delivery	88	89	91	92
3-Day Delivery	83	86	91	90

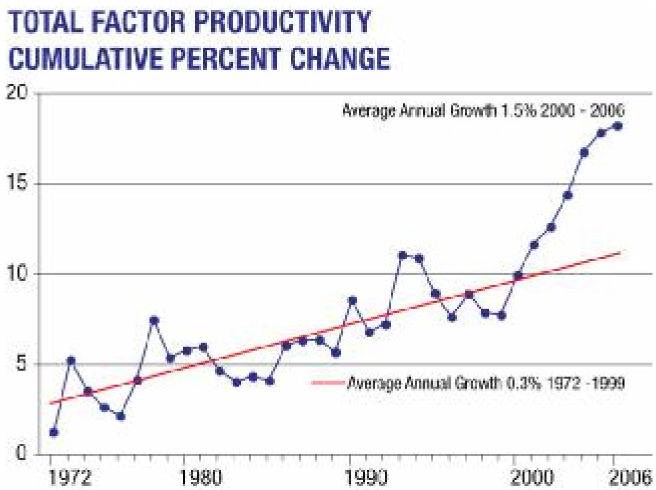
CSM is an independently administered survey of customer opinions of key areas of service to customers. Customer satisfaction has declined from last years high of 94% and we are working to improve this measure. The following table shows the results of these measures for the last four quarters.

Customer Satisfaction Measurement	Quarter 1	Quarter 2	Quarter 3	Quarter 4
(Percentage)				
Service rated excellent, very good or good	92	91	92	92

Productivity

We use a single indicator to measure productivity, which is called total factor productivity (TFP). TFP measures the change in the relationship between outputs, or workload, and all the resources used in producing these outputs. Our main output is delivered mail, special services and carrier service to an expanding delivery network. Our main inputs include labor, materials, transportation and capital deployed.

During 2006, TFP improved 0.4%. This improvement is equivalent to $255 million in expense reductions and marks our seventh consecutive year of TFP growth, equivalent to an expense reduction of $7.0 billion over this time. Weighted mail volume grew 0.3% and other outputs grew by 2.8% and, when combined with 1.5% delivery point growth, yielded an 0.8% increase in workload. We were able to achieve TFP growth by holding increases in resources usage to a lower level than the increase in workload. The following graph shows the development of TFP since 1971.



Capital Investments

The Board of Governors approves the budget for investments in capital each year. The Board also approves all major capital projects, generally defined as projects greater than $25 million. Fiscal Year 2006 began with 44 Board-approved projects in progress, representing $6.5 billion in approved capital. During the year, the Board approved 8 new projects which totaled $882 million in capital. A total of 15 projects representing $1.2 billion in approved funding were completed. Thus, the year ended with 37 open projects amounting to $6.2 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 year end, approximately $5.1 billion had been committed on these 37 projects. Actual payment for these projects, or capital cash outlays, will also occur over several years. Through the end of 2006, approximately $3.5 billion has been paid for the 37 projects.

Of the 37 active Board-approved projects, 25 were for mail processing equipment, 9 for facilities and 3 for other projects such as retail equipment and human resources shared services.

Our total capital commitment plan for 2007 is $3.5 billion, with cash outlays planned at $2.2 billion, of which approximately $1.5 billion are for commitments made in prior years and the remaining $700 million for new commitments in 2007.

Our capital plan supports future needs in 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. 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. We intend to maintain our infrastructure through high priority replacement projects and ongoing repair and alteration projects.

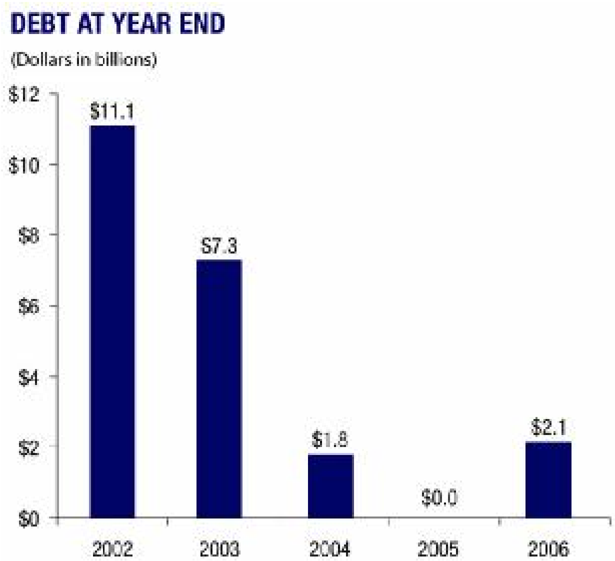
Financing Activities

DEBT

As an "independent establishment of the executive branch of the United States government", we receive no tax dollars for ongoing operations. We are self supporting, and have not received an appropriation for operational costs since 1982. The last time we received any substantial contribution of capital from the U.S. government was in calendar year 1977. We fund our operations chiefly through cash generated from operations. However, unlike companies in the private sector, we are not permitted to raise capital through the equity markets. Consequently our only long term source of outside capital is through borrowing. The uncertainty of the rate setting process influences our cash management strategy.

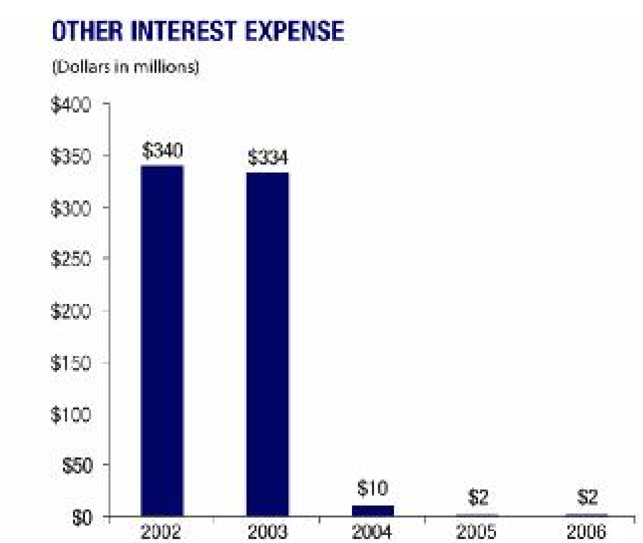
The amount we borrow is largely determined by the difference between our cash flow from operations, our escrow requirement, and our capital cash outlays. Our capital cash outlays are the funds invested back into the business for capital investments in new facilities, new automation equipment and new services. On September 30, 2006, after placing $2,958 million into a restricted escrow account, we borrowed $2.1 billion to fund our capital and operational needs.

In 2005 we paid off all existing debt through cash flows created by "savings" from P.L.108-18. This was the first time since the Postal Reorganization Act of 1970 that we ended the year with no debt obligations outstanding.



Interest Expense

Our 2004 and 2005 debt consisted of short-term debt obligations, which provided us with the flexibility to repay debt with available cash on a daily basis. A major benefit of the short-term obligations was the reduction in interest expense payable to the Federal Financing Bank. As a result, we were able to virtually eliminate interest on debt in 2004, 2005 and 2006 and interest expense on borrowings was the lowest since postal reorganization in the early 1970's.



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

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 in overnight securities issued by the U.S. Treasury. With reduced or zero debt to repay, we took advantage of a build up of cash and rise in short term interest rates to earn investment income of $140 million in 2006, $60 million in 2005.

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 12, *Revenue forgone* in the Notes to the Financial Statements for additional information.

Interest and Investment Income		2006		2005		2004
(Dollars in millions)						
Investment Income	$	140	$	60	$	5
Imputed interest on accounts receivable from the U.S. government		25		25		26
Other Interest		2		1		2
Total	$	167	$	86	$	33

Cash Flow

NET CASH PROVIDED BY OPERATING ACTIVITIES

Net cash provided by operating activities of $3,768 million increased by $38 million over 2005. Increases in cash payments for compensation and transportation expenses were offset by increases to non cash items such as accrued payroll and leave liability of $304 million and workers compensation liability of $342 million. Also contributing was $169 million of increased collections in accounts receivable between 2005 and 2006, increased investment income of $81 million versus 2005, $55 million of additional money orders outstanding at year end as well as a decrease in the interest expense payment on deferred retirement obligations of $32 million..

NET CASH USED IN INVESTING ACTIVITIES

During 2006, 2005, and 2004, net cash used in investing activities was $5.5 billion, $2.3 billion and $1.7 billion respectively. The increases reflect increased investment for mail processing equipment, retail equipment and for building improvements. The increase in 2006 also reflects the placement of $2,958 million into a restricted cash account as required by P.L. 108-18.

NET CASH USED IN FINANCING ACTIVITIES

After funding our escrow requirements for P.L.108-18, we borrowed $2.1 billion to fund capital investments and provide operating cash for future operations. The September 30, 2006 borrowing provided us with two thirds of the $3,230 million increase in cash from September 30, 2005 levels.

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 in 2006, provides for revolving credit lines of $4.0 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 certain statutory limits on borrowing. Our total debt outstanding cannot exceed $15 billion. The net increase in debt at year-end for any fiscal year cannot exceed a $3 billion annual limit, which consists of $2 billion for capital purposes and $1 billion for operating expenses.

At the end of 2006 we made a decision to increase our available cash from $725 million at the end of 2005 to approximately $1 billion on September 30, 2006. We increased our cash balance heading into an environment of perceived increased uncertainty, much like a private sector organization might do. Uncertainties for 2007 include: the results of collective bargaining with four major unions, the health of the overall economy, the outcome and impact of the first fully litigated rate case since R2000-1, an aggressive operating plan dependent on continued increases in productivity, further work hour reductions and whether postal legislation passes with adverse cash flow consequences. Our liquidity will be comprised of the approximately $1 billion of cash that we have entering 2007, the cash flow that we can generate from operations and the $3.0 billion that we can borrow if necessary. As was the case in 2006, for 2007 we do not expect cash flow from operations to supply enough cash to fund both our escrow requirement and our capital investments. Consequently, we anticipate increasing debt next year by at least $1.2 billion. However, this projection is not without risks, and unfavorable events would cause a re-evaluation of the planned 2007 year-end levels of debt.

Other Developments

POSTAL REFORM

Postal reform legislation was considered in the 109th Congress, the continuation of an effort beginning in 1996. Legislation had not yet been approved as Congress returned from its election recess on November 13, 2006. It is possible that postal reform legislation will be considered during this final session of the 109th Congress.

The House passed H.R.22, the Postal Accountability and Enhancement Act on July 26, 2005. The Senate passed its version of the bill on February 9, 2006. The Senate immediately appointed the following conferees: Senators Susan Collins (R-ME); Ted Stevens (R-AK); George Voinovich (R-OH); Norman Coleman (R-MN); Robert Bennett (R-UT); Joseph Lieberman (D-CT); Daniel Akaka (D-HI); and Thomas Carper (D-DE). However, as of November 17, 2006, the House has not named conferees.

The full text of the proposed legislation can be found at the website http://thomas.loc.gov/.

We have voiced our concerns regarding the bill. However, we remain committed to working with the Executive Branch and Congress to advance the legislative effort on postal reform.

SEMIPOSTAL LEGISLATION

Semipostal stamps have a postage value equal to the First-Class Mail non-automation single-piece first-ounce letter rate and are sold at an amount in excess of the postage value to raise money for the designated charitable causes. The amount in excess of the postage value, less reasonable costs incurred by the Postal Service, is distributed to the specified agencies at regular intervals to provide funding for the designated charitable causes.

To date, we have issued three semipostal stamps. These stamps, the Breast Cancer Research stamp, Heroes of 2001 stamp and Stop Family Violence stamp, were specifically mandated by Congress. Sales of the Heroes of 2001 stamp were discontinued December 31, 2004, in accordance with the terms of the legislation.

On November 11, 2005, the President signed P.L.109-100 authorizing the extension of sales of the Breast Cancer Research stamp for two additional years. The stamp is now authorized for sale through December 31, 2007.

Stop Family Violence stamps will be available through December 31, 2006.

In addition to the three Congressionally mandated semipostals, the Semipostal Authorization Act of 2000, P.L.106-253, also gave the Postal Service the authority to "issue and sell semipostals to advance such causes as the Postal Service considers to be in the national public interest and appropriate." The act provides that it "shall cease to be effective at the end of the 10-year period beginning on the date on which semipostals are first made available to the public under this section".

According to implementing rules published by the Postal Service, 39 CFR Part 551, no semipostals will be issued under the Semipostal Authorization Act of 2000 until after the sales period for the Breast Cancer Research stamp has ended. The implementing regulations also provide that the Office of Stamp Services will determine the date of commencement of the ten year period.

APPROPRIATIONS

Although the Postal Service is self-funded and does not receive an appropriation for its operations, we have received appropriations to reimburse us for un-funded statutorily-mandated services.

The 2006 House-passed bill and the Senate reported bill both provide Fiscal Year 2007 funding at almost $109 million, which includes $29 million for revenue forgone and almost $80 million for Free Mail for the blind and overseas voters. The Free Mail funds would not be available until October 1, 2007. These amounts are subject to change because the appropriations process was not finalized by our reporting deadline, and the allocations could be subject to further Congressional action.

ENERGY

A new Energy Initiatives Office was created in 2006 to bring a central focus to our energy issues and to develop an integrated and strategic energy plan that will reduce energy use, minimize the price paid for energy, ensure that legal requirements are met and support continuity of operations.

In 2006, the Postal Service paid nearly $2.4 billion in energy costs to process, transport and deliver the mail. Postal energy costs increased 27% over 2005. The overall increase was driven by fuel which accounted for 74% of our total energy costs.

With more than 216,000 vehicles, the Postal Service has the largest civilian fleet in the United States. We continue to evaluate various fuel types and alternative fuel vehicles including hybrid trucks, hydrogen fuel cell vans, electric step vans, and liquid natural gas delivery vehicles.

The Postal Service occupies over 34,000 buildings and spent $671 million on utilities in 2006. This was a 16% increase over the previous year. We also won the Presidential Award for Leadership in Federal Energy Management as well as a Federal Energy and Water Management Award.

IDENTITY THEFT

Despite widespread expectations, none of the 2005 federal bills that applied data breach notification requirements to private sector firms were able to gain passage in Congress. In May 2006, President Bush directed the Postmaster General and sixteen other agency heads to form the first national Identity Theft Task Force.

The Postmaster General directed the Inspection Service to represent the Postal Service on the Identity Theft Task Force. The Inspection Service and Postal Service Privacy Office provided input that was incorporated into the Task Force interim recommendations released in September. The following day, the White House Office of Management of the Budget issued the Task Force recommendations to all agencies, including the requirement that government agencies use the mail to notify citizens of data security breaches.

TRANSFORMATION PLAN

Since its publication in April 2002, our Transformation Plan has provided focus and direction to all Postal Service business and operating activities. It is our principal planning tool for improving the value of mail and sustaining a financially stable enterprise that meets the nation's needs for affordable and reliable universal service. The plan defines our vision and establishes our strategic goals in the areas of service, revenue, cost savings and human capital.

Transformation assures continuity between our longer-term direction and our near-term corporate objectives, which are published each year as our Annual Performance Plan. It bridges our internal priorities and operating activities with events and conditions in our larger business environment. Transformation in the Postal Service is designed to be dynamic and adaptable. For that reason, the plan was updated at the start of this fiscal year, with the publication of the new *Strategic Transformation Plan, 2006-2010*, which commits us to new advances in service, customer convenience, productivity, and employee engagement. This new plan builds on our successes since 2002. Since 2002 we have seen record levels of on-time service performance for First-Class Mail, as well as record levels of customer satisfaction, as measured by our independently-conducted Customer Satisfaction Measurement, and productivity. Our ease of use and expanded access made it quicker, easier and more convenient than ever for customers to do business with us. We have eliminated more than $5 billion in costs from our 2001 base, and significantly reduced our outstanding debt, which was $11.3 billion in 2001. We have seen strong and steady progress in efficiency, with an unprecedented seventh consecutive year of growth in total-factor productivity. We are delivering almost 50% more mail to 33 million more homes and business than we did 20 years ago, at essentially the same staffing levels. We have seen significant reductions in illnesses, injuries, and workplace disputes due to continued improvements in our workplace environment.

EVOLUTIONARY NETWORK DEVELOPMENT

We have continued our network redesign by focusing on asset optimization within and across our networks.
We continue to take advantage of opportunities created through the ongoing automation deployments to increase efficiency and improve processing quality. Consolidating operations takes advantage of economies of scale improving overall financial performance. For example, Automated Package Processing System (APPS) deployment enables small parcels and bundles to move from decentralized manual or mechanized processing to centralized and automated processing at significantly higher processing speeds. Also, continued letter and flat automation improvements coupled with declining First-Class Mail volume allowed us to consolidate eleven Area Mail Processing (AMP) centers. This should achieve significant savings.

The Bulk Mail Center (BMC) network was created in the 1970's to process parcel post. At that time we deployed state of the art technology, however today the BMC technology is in need of modernization. In 2006, we began to upgrade the BMC network, starting with Kansas City, by removing outdated equipment and replacing it with new automation technology. Additionally, in 2006, we implemented a new transportation strategy, which balances the use of air and surface transportation to reduce cost and improve service performance. We began implementing a national preferential surface transportation network by activating Surface Transfer Centers (STC) in Salt Lake City, Phoenix, and Memphis. The STC network reduces cost by shifting mail from costly air transportation to less costly more reliable surface transportation. We have extended our contracts with select commercial air carriers, United Parcel Service and Federal Express enabling improved service at competitive rates.

We will continue to invest in new equipment, consolidate operations and optimize transportation to keep our network service responsive and affordable.

GLOBAL BUSINESS

In 2006, we created the Global Business organization to manage our worldwide trade to take advantage of opening markets.

OUTLOOK

The economy in 2006 showed trouble signs that are expected to carry forward to 2007 and adversely affect mail volume and revenue growth in the year ahead. We began 2006 with the Hurricane Katrina recovery which led to a spike in energy prices. This spike receded but was eventually followed by a long run up in prices through August 2006 when the world price of oil reached record levels of just over $78 per barrel. While energy prices were rising, housing sales, particularly on the east and west coast were dropping after interest rates increased.

The current omnibus rate case includes a request for an increase in rates of approximately 8.5%. The Postal Rate Commission is expected to issue its recommendations on the request in late 2006 or early 2007. We have assumed for planning purposes that the new rates will be accepted by the Board of Governors and implemented in early May 2007. Any delay will result in missed revenue opportunities of approximately $450 million per month to us.

The demand for all postal products will be reduced in 2007 by three factors. First, the widely expected slowdown in the economy will impact nearly every class of mail negatively. Growth in retail sales, investment spending and employment, all drivers of mail demand, is expected to decline in 2007. Second, in May, the new rate increase will further suppress demand for mailing services. Third, the widespread availability and ease of use of electronic alternatives to mail will continue to depress First-Class Mail.

We project Standard Mail volume growth to plateau at 1.9%, despite a rebound in Standard Regular Rate and Nonprofit Enhanced Carrier Route Mail volume. Standard Regular Rate Mail volume should increase approximately 4.6%. Nonprofit Enhanced Carrier Route Mail will benefit from additional election related volume. In quarter four of 2007, the volume in all subclasses of Standard Mail is expected to decline by 2.2% as the presumed May rate increase takes effect.

Although the demand for First-Class Mail is not particularly price sensitive, it is not immune from rate effects. Therefore the back-to-back rate increases are expected to adversely affect volume growth. First-Class Mail single-piece letters are expected to continue to decline due to electronic diversion and rate increases. Workshare letter volume is expected to decline 1.5%, for the first time since 2003. Workshare letters are affected by electronic diversion but to a lesser extent than single piece letters. However, the slowdown in retail sales will contribute to the softness in workshare letter demand.

In both 2005 and 2006 Priority Mail volume had rebounded from several years of declines. Priority Mail competes in a very competitive market and is considerably more price sensitive than First-Class Mail. We expect Priority Mail volume to be affected by the back-to-back rate increases and decline by 3.9% in 2007. Express Mail has higher price sensitivity than Priority Mail and is expected to decrease by 7.8% in 2007. The demand for these two products is dependent on competitors' prices that include fuel surcharges. Therefore uncertainty with regard to future fuel prices contributes an added degree of uncertainty to the projection of Priority Mail and Express Mail volume.

Package Services volume is expected to decline 13 million pieces or 1.1% in 2007. Retail Parcel Post is expected to increase 1.2% but Parcel Select is expected to decline 3.1% as retail Parcel Post is much less price sensitive than Parcel Select. Projected Bound Printed Matter volume increases of 1.3% are expected to be offset by an 8.1% volume loss in Media and Library Mail. Growing our business to exceed these forecasts is a major priority in 2007.

Periodical Mail volume is projected to decline 2.7% in 2007. In addition to being affected by the factors mentioned above, Periodicals Mail is driven by the changing reading habits of many Americans.

We project revenue to increase by $2.5 billion, or 3.4% to $75.3 billion in 2007. Most of this increase is due to the anticipated rate increase. Even though mail volume will be lower, revenue will increase.

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 its peak in 2001, First-Class Mail volume has decreased by 6.1 billion pieces while our delivery network has expanded through the addition of over 8 million new delivery points. Furthermore, we operate a retail network anchored by almost 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 almost 2 million delivery points to our network. 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.

Despite the recent slowdown in the housing market, long-term trends for housing can be expected to track long-term trends in population. We expect the number of delivery points to continue to grow in the future. Household growth will translate into a continuing expansion of our delivery network. As the population and delivery network continue to grow, we expect First-Class Mail volume to continue to decline. This combination of trends will continue to challenge us to build all other postal business and increase productivity to continue to finance the nation's universal delivery system.

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.

The back-to-back rate increases in 2006 and 2007 have two different underlying causes. The January 2006 rate increase was designed only to cover escrow related provisions of P.L.108-18. The 2007 rate increase will be the first rate increase associated with covering postal operating expense increases since 2002. Despite the fact that $1.1 billion of cost reductions are planned for 2007, 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. Further rate increases will be necessary to fund our expense increases.

EXPENSE GROWTH

We estimate that total expenses in 2007 will be $73.6 billion, a 2.3% increase over our 2006 expenses of $71.9 billion. We expect personnel costs and our cost per workhour to increase. This increase will be driven primarily by cost-of-living pay adjustments and potential contractual pay increases that may be incurred through collective bargaining with our unions.

We expect non-personnel expenses, excluding transportation and interest expenses, to increase approximately $242 million, or 2.6%. Transportation expenses are expected to grow $214 million, or 3.5% over 2006 due to higher fuel costs.

The 2007 plan reduces workhours by 40 million hours below the 2006 total. Our planned workhour reduction target is equal to approximately 20,000 full-time equivalent employees. This will be the seventh out of the last eight years in which we have reduced workhours. The workhour reductions are a product of process improvements, automation through capital investment programs and a projected volume decline.

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 resulted in a lower revenue-per-piece mix. If this accelerates beyond what has been projected it will have a more significant effect on revenue.

Economic Risk

The demand for all postal services is heavily influenced by changes in the economy. The widely expected slowdown in the economy will impact nearly every class of mail negatively in the coming year. Growth in retail sales, investment spending and employment, all drivers of mail demand, is expected to decline in 2007 and may further reduce forecasted results.

General Inflation Risk

Each of our labor contracts with our largest unions currently includes provisions granting COLAs. These agreements expire on November 20, 2006. Under the current contracts, COLA adjustments are generally granted semi-annually and are linked to increases in the consumer price index (CPI). Non-bargaining employees do not receive COLAs, but are eligible for pay for performance increases. Because employee compensation represents a significant portion of our annual expenses, and COLAs may be a component of future labor contracts, 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.

Fuel Price Risk

Fuel prices are a significant part of our expenses. We are exposed to changes in commodity prices primarily for diesel fuel, unleaded gasoline, aircraft fuel for transportation of the mails and natural gas for heating facilities. A 1.0% change in fuel and natural gas costs would result in more than a $48 million increase in our expenses on average. 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, Japanese yen, pound sterling, and 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. The revaluation did not significantly impact our financial statements. 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

Our Statements of Operations, Balance Sheets, Statements of Changes in Net Capital and Statements of Cash Flows are available in the Financial Statements section 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.

Internal Controls

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

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 initial employee orientation training and other times during the year. We also provide annual ethics training for all employees who file a financial disclosure report. To support our employees on ethical issues, we maintain a dedicated phone line and e-mail address for providing ethical advice.

Financial Review
Part III

Item 10 – Directors and executive officers

Board of Governors

James C. Miller III
Chairman

Alan C. Kessler
Vice Chairman

Mickey D. Barnett
Member

James H. Bilbray
Member

Carolyn Lewis Gallagher
Member

Lewis J. Giuliano
Member

Katherine C. Tobin
Member

Ellen C. Williams
Member

John E. Potter
Postmaster General and Chief Executive Officer

Patrick R. Donahoe
Deputy Postmaster General and Chief Operating Officer

On September 29, 2006, President Bush nominated Thurgood Marshall Jr. to the Board of Governors. If confirmed by the United States Senate, Mr. Marshall will be a Governor for the remainder of a nine-year term, which will expire Dec. 8, 2011.

Executive Committee

John E. Potter
Postmaster General and Chief Executive Officer

Patrick R. Donahoe
Deputy Postmaster General and Chief Operating Officer

H. Glen Walker
Chief Financial Officer and Executive Vice President

Anita J. Bizzotto
Chief Marketing Officer and Executive Vice President

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

Thomas G. Day
Senior Vice President, Government Relations

Mary Anne Gibbons
Senior Vice President and General Counsel

Linda A. Kingsley
Vice President, Strategic Planning

Officers

Kathy Ainsworth
Vice President, Delivery and Retail (acting)

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)

Susan M. Brownell
Vice President, Supply Management

Ellis A. Burgoyne
Vice President, Area Operations (Southwest)

William A. Campbell
Judicial Officer

Michael J. Daley
Vice President, Area Operations (Pacific)

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

William Galligan
Senior Vice President, Operations

Deborah Giannoni-Jackson
Vice President, Employee Resource Management

Lee R. Heath
Chief Postal Inspector

Stephen M. Kearney
Vice President, Pricing and Classification

Delores J. Killette
Vice President and Consumer Advocate

Susan M. LaChance
Vice President, Employee Development and Diversity

Jerry Lane
Vice President, Area Operations (Capital Metro)

Officers (continued)

Alexander Lazaroff
Vice President, Area Operations (Eastern)

Jon A. Leonard
Vice President, Public Affairs and Communications (acting)

Lynn Malcolm
Vice President, Controller

Walter F. O'Tormey
Vice President, Engineering

Robert L. Otto
Vice President, Chief Technology Officer

Anthony M. Pajunas
Vice President, Network Operations Management

Henry A. Pankey
Vice President, Emergency Preparedness

Robert J. Pedersen
Vice President, Treasurer

Susan Plonkey
Vice President, Customer Service

Tom A. Samra
Vice President, Facilities

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

Douglas A. Tulino
Vice President, Labor Relations

Paul Vogel
Senior Vice President and Managing Director, Global Business

Jerry W. Whalen
Vice President, Sales

Terry Wilson
Vice President, Area Operations (Southeast)

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 www.usps.com.

Item 12 – Security ownership of certain beneficial owners and management related stockholder matters

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

Item 13 – Certain relationships and related transactions

As discussed in Item 9A, *Controls and procedures,* every Postal Service executive, 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.

We enter into significant transactions with other government agencies, as disclosed throughout these financial statements.

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
Quality In Everything We Do

Ernst & Young LLP
8484 Westpark Drive
McLean, VA 22102

Phone: (703) 747-1000
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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, 2006 and 2005, and the related statements of operations, changes in net capital and cash flows for each of the three years in the period ended September 30, 2006. 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, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2006 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 13, 2006 and November 14, 2005, for fiscal years 2006 and 2005, 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 13, 2006

Statements of Operations

	Years Ended September 30,		
	2006	**2005**	**2004**
(Dollars in millions)			
Operating revenue	$ 72,650	$ 69,907	$ 68,996
Operating expenses:			
Compensation and benefits	56,281	53,932	52,134
Transportation	6,045	5,437	4,969
Other	9,358	8,914	8,748
Total operating expenses	71,684	68,283	65,851
Income from operations	**966**	**1,624**	**3,145**
Interest and investment income	167	86	33
Interest expense on deferred retirement obligations	(231)	(263)	(103)
Other interest expense	(2)	(2)	(10)
Net Income	**$ 900**	**$ 1,445**	**$ 3,065**

See accompanying notes to the financial statements

Balance Sheets - Assets

	September 30, 2006	September 30, 2005
(Dollars in millions)		
Assets		
Current Assets		
Cash and cash equivalents	$ 997	$ 725
Receivables:		
Foreign countries	527	590
U.S. government	150	280
Other	210	188
Receivables before allowances	887	1,058
Less allowances	48	50
Total receivables, net	839	1,008
Supplies, advances and prepayments	205	200
Total Current Assets	**2,041**	**1,933**
Cash - Restricted	**2,958**	**-**
Appropriations Receivable - Revenue Forgone	**394**	**376**
Property and Equipment, at Cost:		
Buildings	21,083	20,480
Equipment	19,729	18,664
Land	2,887	2,878
Leasehold improvements	1,232	1,172
	44,931	43,194
Less allowances for depreciation and amortization	23,951	22,400
	20,980	20,794
Construction in progress	2,115	1,895
Total Property and Equipment, Net	**23,095**	**22,689**
Total Assets	**$ 28,488**	**$ 24,998**

See accompanying notes to the financial statements

Balance Sheets – Liabilities and Net Capital

(Dollars in millions)	September 30, 2006	2005
Liabilities and Net Capital		
Current Liabilities:		
Compensation and benefits	$ 3,224	$ 2,852
Payables and accrued expenses:		
Trade payables and accrued expenses	1,481	1,363
Foreign countries	567	688
U.S. government	111	76
Total payables and accrued expenses	2,159	2,127
Customer deposit accounts	1,647	1,720
Deferred revenue-prepaid postage	1,187	1,200
Outstanding postal money orders	885	830
Prepaid box rent and other deferred revenue	454	477
Debt	2,100	-
Total Current Liabilities	**11,656**	**9,206**
Non-Current Liabilities:		
Workers' compensation costs	6,869	6,695
Employees' accumulated leave	2,116	2,016
Deferred appropriations revenue	631	692
Long term portion capital lease obligations	637	644
Other	303	369
Total Non-Current Liabilities	**10,556**	**10,416**
Total Liabilities	**22,212**	**19,622**
Net Capital		
Capital contributions of the U.S. government	3,034	3,034
Retained earnings since reorganization	3,242	2,342
Total Net Capital	**6,276**	**5,376**
Total Liabilities and Net Capital	**$ 28,488**	**$ 24,998**

See accompanying notes to the financial statements

Statements of Changes in Net Capital

Years ended September 30, 2006, 2005 and 2004

(Dollars in millions)	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital
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
Net Income	-	900	900
Balance, September 30, 2006	**$ 3,034**	**$ 3,242**	**$ 6,276**

See accompanying notes to the financial statements

Statements of Cash Flows

(Dollars in millions)	Years Ended September 30, 2006	2005	2004
Cash flows from operating activities:			
Net income	$ 900	$ 1,445	$ 3,065
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,149	2,089	2,145
(Gain) loss on disposals of property and equipment, net	(40)	5	71
(Increase) decrease in appropriations receivable revenue forgone	(18)	(15)	4
Increase (decrease) in workers' compensation liability	342	(58)	343
Increase in employees accumulated leave	100	10	74
(Decrease) increase in non-current deferred appropriations revenue	(61)	(99)	288
(Decrease) in other non-current liabilities	(66)	(12)	(76)
Changes in current assets and liabilities:			
Decrease in receivables, net	169	16	167
(Increase) decrease in supplies, advances and prepayments	(5)	20	146
Increase in compensation and benefits	204	314	106
(Decrease) in deferred revenue-prepaid postage	(13)	(56)	(93)
Increase (decrease) in payables and accrued expenses	148	(158)	(82)
(Decrease) increase in customer deposit accounts	(73)	114	40
Increase (decrease) in outstanding postal money orders	55	63	(1)
(Decrease) increase in prepaid box rent and other deferred revenue	(23)	52	(368)
Net cash provided by operating activities	3,768	3,730	5,829
Cash Flows from investing activities:			
Increase in restricted cash	(2,958)	-	-
Purchase of property and equipment	(2,630)	(2,317)	(1,685)
Proceeds from sale of property and equipment	114	31	26
Net cash used in investing activities	(5,474)	(2,286)	(1,659)
Cash flows from financing activities:			
Issuance of debt	2,100	-	-
Payments on debt	-	(1,800)	(5,473)
Payments for capital lease obligations	(37)	16	(48)
U.S. government appropriations - received	-	503	-
U.S. government appropriations - expended	(85)	(45)	(92)
Net Cash provided by (used in) financing activities	1,978	(1,326)	(5,613)
Net increase (decrease) in cash and cash equivalents	272	118	(1,443)
Cash and cash equivalents at beginning of year	725	607	2,050
Cash and cash equivalents at end of year	$ 997	$ 725	$ 607

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 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. This fulfills our legal mandate to offer universal service at a fair price. We conduct our operations primarily in the domestic market, with international operations representing less than 3% of our total revenue.

Our primary lines of service are First-Class Mail, Priority Mail, Express Mail, Periodical Mail, Standard Mail, Package Services and International Mail. The principal markets for these services are the communications, distribution, delivery, advertising and retail markets. Our services (products) are sold and distributed through almost 37,000 Post Offices, stations, branches, contract postal units, a large network of consignees, over 600 processing facilities and almost 1,000 administrative and support facilities.

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Over 85% of our career employees are covered by collective bargaining agreements. The agreements with the major unions expire November 20, 2006. Information on labor agreements can be found on our website www.usps.com.

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.

Postal Reorganization

We commenced operations on July 1, 1971, in accordance with the provisions of the Postal Reorganization Act (the Act). We are an "independent establishment" of the executive branch of the U.S. government. Governing decisions are made by a Board of Governors appointed by the President with the advice and consent of the Senate.

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 $3.034 billion. The U.S. government remains responsible for all the liabilities attributable to operations of the former Post Office Department, however, under the Balanced Budget Act of 1997, the liability for Post Office Department workers' compensation costs was transferred to us.

We 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 ratemaking process provides for the recovery of financial losses through future rate increases.

The Act established the independent Postal Rate Commission (PRC) with oversight responsibility for recommending fair and equitable rates of postage and fees, subject to approval by the Governors of the Postal Service.

Note 2 – Summary of significant accounting policies

Basis of Accounting and Use of Estimates

We conform to accounting principles generally accepted in the United States. We maintain our accounting records and prepare our financial statements on the accrual basis of accounting. 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.

Notes to the Financial Statements

Segment Information

We operate in one segment throughout the United States, it possessions, territories and internationally.

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.

We currently recognize checks outstanding as a reduction of cash. We previously recognized checks outstanding as a current liability until presented for payment. Due to this 2006 change in accounting policy we have reclassified our balance sheets and statements of cash flow as required by GAAP. This reclassification had no effect on our previously reported net income.

Cash and Cash Equivalents

We consider securities that mature within 90 days or less from the date we buy them as cash equivalents.

Cash - Restricted

We maintain a restricted cash account in conformity with statutes set forth in P.L.108-18 to set aside "savings" See Note 10, *Retirement programs* for additional information. Restricted cash is reported as a non-current asset.

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 doubtful accounts methodology, based on our last five years of collection history. This change in estimate reduced our allowance from $111 million in 2004, to $50 million at the end of 2005. In 2006 our allowance was $48 million.

Supplies Inventory

Our inventory is comprised of motor vehicle repair parts and repair parts for mail processing equipment. We value our inventories at the lower of average cost or market price. Total inventories amounted to $125 million at the end of 2006 and $119 million at the end of 2005.

Property and Equipment

We record property and equipment at cost, including the interest we pay on the money we borrow to pay for the construction of major capital additions. See Note 5, *Property and equipment* for additional information.

We depreciate buildings and equipment over their estimated useful lives, which range from 3 to 40 years, except buildings with historic status which are depreciated over 75 years, using the straight-line method.

Impaired Assets

We record losses on long-lived assets when events and circumstances indicate that the assets might be impaired. In accordance with Financial Accounting Standards Board Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we write down our impaired assets to the lower of cost or fair value. See Note 5, *Property and equipment* for additional information.

Asset Retirement Obligations

We account for our asset retirement obligations in accordance with Financial Accounting Standards Board Interpretation 47, Accounting for Conditional Asset Removal (FIN 47).

In March 2005, the FASB issued FIN47, which requires a liability to be accrued if the reporting entity has a legal obligation to perform asset retirement activities and a reasonable estimate of the fair market value of the obligation can be made at year-end. FIN 47 also provides guidance as to when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. We adopted the provisions of FIN 47 effective October1, 2005. The adoption of FIN 47 had no effect on our financial statements.

Amortization of Leasehold Improvements

We amortize leasehold improvements over the period of the lease or the useful life of the improvement, whichever is shorter.

Leasehold improvements that are placed in service significantly after the start of the lease term are amortized over the shorter of the useful life of the asset or the lease term including expected renewal options.

Notes to the Financial Statements

Foreign Currency Translation

We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail. The majority of our international accounts are denominated in special drawing rights (SDRs). The SDR exchange rate fluctuates daily based on a basket of currencies comprised of the euro, Japanese yen, pound sterling and the U.S. dollar. Changes in the relative value of these currencies will increase or decrease the value of our settlement accounts and result in a gain or loss from revaluation reported in the results from operations. The actual currency used to settle accounts varies by country. See Note 6, *Foreign currency translation* for additional information.

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 money orders we expect to be presented for payment.

Valuation of Debt 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 notes.

Revenue Recognition/Deferred Revenue-Prepaid Postage

We recognize revenue when service is rendered. Deferred revenue-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.

Advertising Expenses

Advertising costs are expensed as incurred and are classified in other operating expenses. Advertising expenses were $138 million in 2006, $143 million in 2005 and $108 million in 2004.

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.

Workers' Compensation

We pay for workers' compensation costs under a program administered by the Department of Labor (DOL). These costs include employees' medical expenses, payments for continuation of wages and DOL administrative fees. We record these costs as an operating expense. See Note 11, *Workers compensation* for additional information.

Retiree Benefits

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 using multi-employer plan accounting rules in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* We account for employee and retiree health benefit costs as an expense in the period our contribution is due and payable to the FEHBP. See Note 9, *Health benefits programs* for additional information.

RETIREMENT BENEFITS

We are an independent establishment of the executive branch of the U.S. government. We provide pension benefits as defined and administered by the Office of Personnel Management (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 U.S. government sponsored retirement plans using multi-employer plan accounting rules in accordance with Financial Accounting Standards Board Statement 87, *Employers' Accounting for Pension Costs*. See Note 10, *Retirement programs* for additional information.

Revenue Forgone Appropriation

Revenue Forgone is an appropriation from Congress which covers our cost of providing free and reduced rate mailing service to groups designated by Congress. The amount of expense estimated by the Postal Service is submitted to Congress annually and Congress subsequently approves or alters the amount and funds the necessary appropriation. See Note 12, *Revenue forgone* for additional information.

Emergency Preparedness Appropriation

Emergency preparedness appropriations are the funds we received from the federal government to help pay the costs of keeping the mail, postal employees and postal customers safe and are restricted for such use. Upon receipt of the funds, we established a liability. As we recognize emergency preparedness operating expenses, we recognize operating revenue. See Note 13, *Emergency preparedness funding* for additional information.

Note 3 – Recent pronouncements

Currently no new pronouncements are pending that have not been incorporated into our accounting policies.

Note 4 – Debt and related interest

Borrowing Limits and Debt

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

On September 30, 2006, we borrowed $2.1 billon in short term debt. Debt consists of $2.1 billion in cash drawn on our line of credit with the Federal Financing Bank. At September 30, 2005, no debt was outstanding on our balance sheet. At year-end, the current estimated market value of our debt is $2.1 billion.

This debt was paid October 3, 2006.

Interest Payments on Retirement

Cash outlays for interest on the retirement "supplemental liability," were $231 million in 2006, $263 million in 2005, and $219 million in 2004. See Note 10, *Retirement programs* for additional information.

Interest on retirement is primarily all of our interest expense.

Note Purchase Agreements

Our Note Purchase Agreements with the Federal Financing Bank 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 5 – Property and equipment

Interest Capitalization

No interest was capitalized in 2006 and 2005 as no outstanding debt balance was carried for this period, except on September 30, 2006. In 2004, interest was capitalized in the amount of $5 million.

Repairs and Maintenance

Repairs and maintenance are charged to expense as incurred. This expense amounted to $933 million in 2006, $809 million in 2005 and $744 million in 2004.

Impaired Assets

In 2006, we had no newly reported impaired assets.

In 2005, hurricane Katrina devastated the gulf coast and damaged many of our facilities in that area. As a result we recorded an estimated loss of $7.5 million for impaired assets.

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 order to reduce the carrying value of the property to its estimated fair value, including the cost of necessary repairs. In 2006, we recorded an additional charge of $9 million related to this property.

Notes to the Financial Statements

Note 6 – Foreign currency translations

Special Drawing Rights

We operate in one segment for our business. We regularly exchange mail with foreign postal administrations for incoming and outgoing international mail which results in receivables and payables for terminal dues and transit fees. Under Universal Postal Union rules, each country agrees to value transactions in Special Drawing Rights. Therefore the majority of our international accounts are denominated in SDRs. The SDR exchange rate fluctuates daily based on a basket of currencies comprised of the euro, Japanese yen, pound sterling and the U.S. dollar. Changes in the relative value of these currencies will increase or decrease the value of our settlement accounts and result in a gain or loss from revaluation reported in the results from operations. The actual currency used to settle accounts varies by country.

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 impacts on our financial statements from foreign currency fluctuations were insignificant for 2006, 2005 and 2004.

Note 7 – Commitments

Capital

At September 30, 2006 we estimate our financial commitment for approved capital projects in progress (resources on order) to be $2,760 million, detailed in the following table.

Capital Resources on Order	2006
(Dollars in millons)	
Mail Processing Equipment	$ 1,483
Postal Support Equipment	476
Building Improvements	517
Construction and Building Purchase	228
Vehicles	18
Retail Equipment	38
Total Capital Resources on Order	$ 2,760

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

Rental Expense	2006	2005	2004
(Dollars in millions)			
Non-cancelable real estate leases including related taxes	$ 953	$ 892	$ 896
Facilities leased from GSA subject to 120-day cancellation	49	42	49
Equipment and other short-term rentals	192	209	213
Total Rental Expense	$ 1,194	$ 1,143	$ 1,158

At September 30, 2006 our future minimum lease payments for all non-cancelable leases are as follows:

Lease Obligations	Operating	Capital
(Dollars in millions)		
2007	$ 733	$ 95
2008	722	93
2009	691	90
2010	641	87
2011	582	85
After 2011	5,027	621
Total Lease Obligations	$ 8,396	$ 1,071
Less: Interest		398
Total Capital Lease Obligations		$ 673
Less: Short-term portion of capital lease obligations		36
Long-term Portion of Capital Lease Obligations		$ 637

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 $891 million in 2006 and $906 million in 2005. Total accumulated amortization is $350 million in 2006 and $318 million in 2005. Amortization expense for assets recorded under capital leases is recorded as depreciation expense which is included in "Other" operating expenses in the statements of operations.

Expense

Notes to the Financial Statements

In the normal operations of our business we enter into commitments for expense contracts. The contracts run for periods from one to ten years. Although these contracts contain clauses for termination by the Postal Service, we normally would have early termination costs.

Expense commitments are classified as miscellaneous, inventory and research and development. Our miscellaneous expense commitments include contracts for supplies, services, communications, repairs, research, printing and advertising. Our inventory contracts are for vehicle repair parts and mechanized equipment spare parts. These are summarized in the following table.

Expense Resources on Order	2006
(Dollars in millons)	
Miscellaneous Contracts	$ 4,885
Inventory Contracts	253
Research and Development Contracts	39
Total Expense Resources on Order	$ 5,177

Note 8 – Contingent liabilities

Our contingent liabilities consist mainly of claims and suits resulting from labor issues, equal employment opportunity issues, environmental issues, property damage claims, injuries on postal properties, issues arising from postal contracts, personal claims and traffic accidents.

Each quarter we review significant new claims and litigation for the probability of an adverse outcome. If the claim is deemed "probable" for an unfavorable outcome and the amount of settlement is estimable, we record a liability. Each quarter we also review and adjust any prior contingencies for settlements, or revisions to prior estimates. No individual claim is material to our financial statements when taken as a whole. The following table summarizes our contingent liabilities provided for in the financial statements.

Contingent Liabilities	2006	2005
(Dollars in millions)		
Labor Cases	$ 254	$ 308
Equal Employment Opportunity Cases	66	79
Tort Cases	57	49
Environmental Cases	25	25
Contractual Cases	16	8
Total Contingent Liabilities	$ 418	$ 469

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

We also have similar type cases which we deem reasonably possible and for which we cannot yet determine the amounts or a reasonable range of potential losses in these matters, if any.

Note 9 – Health benefit programs

Current Employees

Substantially all of our employees are covered by the U.S. government health plan, FEHBP. OPM administers the program and allocates the cost of the program to the various participating government agency employers. We cannot direct the costs, benefits, or funding requirements of the federally-sponsored plan and therefore are required to use multi-employer plan accounting rules.

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 2006, 2005 and 2004. We paid the remainder of employee health care expense which was $5,345 million in 2006, $5,100 million in 2005 and $4,845 million in 2004.

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

Notes to the Financial Statements

Retirees

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.

Our retiree health benefit expenses amounted to $1,637 million in 2006, $1,495 million in 2005 and $1,313 million in 2004. We include these costs in our compensation and benefits expense.

Note 10 – Retirement programs

Pension Programs

With certain exceptions, employees participate in one of the following pension programs based upon the starting date of their employment with the Federal Government. Employee and employer contributions are made to 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 Savings Plan (TSP), which is a defined contribution retirement savings and investment plan. Postal Service employees are authorized to participate in the TSP 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 TSP contributions for employees who participate in CSRS. In addition, employees hired before January 1, 1984, could choose during certain periods in 1987, 1988 and 1998 to participate in FERS.

DUAL CSRS

Employees with prior U.S. government service who were hired between January 1, 1984, and January 1, 1987, are covered by Dual CSRS, 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 TSP contributions for employees who participate in Dual CSRS.

FERS

Effective January 1, 1987, officers and career employees hired since December 31, 1983 are covered by the Federal Employees Retirement System Act of 1986, except for those covered by Dual CSRS. Included are employees formerly covered by CSRS who elected in 1987, 1988 and 1998 to participate in FERS.

This system consists of Social Security, a basic annuity plan, and TSP. 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 TSP 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.

Employee / Employer Contributions

Employer and employee base contributions, as a percentage of employee basic pay, are as follows for each of the three plans for 2006, 2005, and 2004:

Retirement Contribution	2006	2005	2004
(Percentage)			
CSRS Employer	17.4	17.4	17.4
CSRS Employee	7.0	7.0	7.0
Dual CSRS Employer	18.0	18.0	18.0
Dual CSRS Employee	0.8	0.8	0.8
FERS Employer	11.2	11.2	10.7
FERS Employee	0.8	0.8	0.8

Notes to the Financial Statements

The number of employees enrolled in each of the retirement plans at the end of 2006, 2005, and 2004 is as follows:

Retirement Enrollment by Program	2006	2005	2004
(Actual numbers)			
CSRS	157,945	171,958	188,670
Dual CSRS	8,150	8,640	9,238
FERS	530,043	524,118	509,577

Expense Components

The following table lists the components of our total retirement expenses that are included in compensation and benefits expense and related interest expense in the Statements of Operations for 2006, 2005 and 2004.

Retirement Expense	2006	2005	2004
(Dollars in millions)			
CSRS	$ 1,450	$ 1,533	$ 1,641
FERS	2,652	2,510	2,255
FERS Thrift Savings Plan	960	912	877
Dual CSRS	75	78	76
Social Security	1,843	1,750	1,610
CSRS "Supplemental Liability"	26	27	12
Subtotal Expense	$ 7,006	$ 6,810	$ 6,471
CSRS "Supplemental Liability" Interest Expense	231	263	103
Total Retirement Expense	$ 7,237	$ 7,073	$ 6,574

Employer cash contributions to retirement plans were $5,122 million in 2006, $5,014 million in 2005, and $4,827 million in 2004. These amounts do not include Social Security contributions and interest expense on deferred retirement liabilities.

P.L.108-18

On April 23, 2003, the President signed into law P.L.108-18, the Postal Civil Service Retirement System Funding Reform Act of 2003, which changed the way we contribute to the CSRS retirement plan. Although the law changed the funding of the plan, we determined that we would still use multi-employer pension plan accounting treatment rules as an "independent establishment of the executive branch of the United States government".

We are required by P.L.108-18 to pay an additional annual amount if necessary, as determined by OPM, each September, beginning in 2004. 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.

In September 2006, OPM estimated the present value of benefits at $196.9 billion, contributions at $12.3 billion, and plan assets at $180.9 billion as of September 30, 2005. The calculated September 2005 "supplemental liability" of $3.7 billion, was a decrease of $500 million from the $4.2 billion "supplemental liability" as of September 30, 2004. This calculation assumed general salary increases of 2.8%, COLAs of 3.25%, and interest of 6.25% and is intended to provide for the liquidation of the "supplemental liability" over a 38-year period ending in September 30, 2043. The following table presents OPM's estimate of the present value of our CSRS "Supplemental Liability".

Present Value Analysis of CSRS "Supplemental Liability"	2005	2004
(Dollars in billions as of September 30)		
Present Value of Benefits	$ 196.9	$ 195.0
Present Value of Contributions *	$ 12.3	$ 14.1
Current Fund Balance	$ 180.9	$ 176.7
Deficit	$ (3.7)	$ (4.2)

* Expected employer and employee contributions

Our "supplemental liability" payment in 2006 was $257 million, a decrease of $33 million over the $290 million payment in 2005. Our first "supplemental liability" payment in 2004 was $240 million.

P.L.108-18 also required that we place in escrow, by September 30, 2006, any "savings" until Congress decides the final disposition of "savings" from the change in the retirement funding provisions. OPM calculated the savings at $2,958 million.

Notes to the Financial Statements

Note 11 – Workers' compensation

We pay for workers' compensation costs under a program administered by DOL. These costs include employees' medical expenses, payments for continuation of wages and DOL administrative fees. We record these costs as an operating expense.

Our liability at September 30, 2006, represents the estimated present value of the total amount we expect to pay in the future for postal workers injured through the end of 2006. 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 2006 and 2005, a net discount rate of -0.8% for medical expenses and 3.3% for compensation claims was used. At the end of 2006, we estimate our total liability for future workers' compensation costs at $7,863 million. At the end of 2005 this liability was $7,521 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 $676 million. A decrease of 1% would increase our estimate of the liability by approximately $824 million.

In 2004, the net discount rates used to determine the present value of estimated future workers' compensation payments was changed, 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 of 5.5% will exceed our investment returns of 4.7% by 0.8% per year over the expected life of the medical claims. Conversely we believe that our assumed investment returns of 5.5% will exceed the rate of inflation on the consumer wages index of 2.2% by 3.3% over the expected life of the compensation claims. Due to the differing average lengths claimants stay on the rolls between medical and compensation claims, we use two different market baskets of bonds funds to calculate our expected returns.

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 as defined by GAAP

In 2006, we recorded $1,279 million in workers' compensation expense, compared to the $838 million in 2005 and $1,239 million recorded in 2004.

In addition to the cost of workers' compensation claims, OWCP charges us an administrative fee for processing claims. In 2006, the administrative fee, which is included in the expense above, was $45 million, compared to $56 million in 2005 and $44 million in 2004.

Note 12 – Revenue forgone

Our operating revenue includes accruals for revenue forgone. Revenue is forgone when Congress mandates that we provide free or reduced fee mail for designated mailers. Congress appropriates money to reimburse us for the revenue that we have forgone in providing these services.

In 2006 we included as operating revenue $99 million, $109 million for 2005, and $36 million for 2004.

We estimate the amount of service that will be provided in the current year and send a request to Congress. At the end of the year we reconcile the request with the actual usage. If the actual usage is higher than our estimate we send a supplemental request to Congress for additional funding. If the actual usage is lower, we offset the over funding against the next funding request. The requested amounts are recorded as government receivables until the appropriations are received.

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 non-profit 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 $357 million in 2006 and $360 million in 2005.

The total receivable for revenue forgone as of the years ended September 30 was $490 million in 2006 and $470 million in 2005.

Note 13 - Emergency preparedness funding

In 2001, the United States was a victim of biological terrorism through the mail. 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 fiscal year 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. As of September 30, 2004, all 2002 emergency preparedness appropriations were fully expended or committed.

In December 2004, an appropriation by Congress of $503 million provided additional funds for Biohazard Detection Systems, Ventilation Filtration Systems, and an irradiation facility. Of these funds $138 million remains to be expended or committed.

We recognize the revenue as we depreciate the capital equipment purchased with the appropriation. The emergency preparedness appropriations revenue recognized during the years ended September 30 were $85 million in 2006, $45 million in 2005, and $92 million in 2004.

Appropriations that have not been recognized as revenue during the years ended September 30 were $687 million in 2006 and $772 million in 2005 with the current portion included in prepaid box rent and other deferred revenue and the long term portion in deferred revenue on our balance sheets.

The emergency preparedness expenses and capital equipment commitments for the years ended September 30 are as follows:

Emergency Preparedness Expenses and Commitments	2006	2005	2004
(Dollars in millions)			
Operating Expenses:			
Personnel Costs	$ -	$ -	$ 9
Non-Personnel Costs	196	79	123
Total Operating Expenses	$ 196	$ 79	$ 132
Capital Equipment Commitments	$ 72	$ 313	$ 222

Not all emergency preparedness expenditures are covered by the appropriations we receive. 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.

Note 14 - Postal Reform

Postal reform legislation was considered in the 109th Congress, the continuation of an effort beginning in 1996. Legislation had not yet been approved as Congress returned from its election recess on November 13, 2006. It is possible that postal reform legislation will be considered during this final session of the 109th Congress.

Operating Statistics

Category of Service	2006	2005	2004	2003	2002
(In millions of units indicated, unaudited)					
First Class Mail					
Revenue	$ 37,038.8	$ 36,061.8	$ 36,376.8	$ 37,048.3	$ 36,483.2
Pieces, Number	97,617.5	98,071.0	97,926.4	99,058.7	102,378.6
Weight, Pounds	4,376.0	4,369.9	4,389.9	4,236.3	4,283.6
Standard Mail					
Revenue *	$ 19,876.8	$ 18,953.5	$ 18,122.5	$ 17,231.3	$ 15,818.8
Pieces, Number *	102,459.6	100,942.1	95,563.5	90,492.2	87,230.6
Weight, Pounds *	11,771.2	11,656.5	11,148.3	10,827.6	10,315.5
Priority Mail					
Revenue	$ 5,042.5	$ 4,633.6	$ 4,421.4	$ 4,494.3	$ 4,722.5
Pieces, Number	924.2	887.5	848.6	859.6	998.2
Weight, Pounds	1,809.5	1,690.7	1,623.3	1,622.9	1,875.1
Package Services					
Revenue	$ 2,259.0	$ 2,201.1	$ 2,206.9	$ 2,215.7	$ 2,080.1
Pieces, Number	1,174.6	1,165.5	1,131.9	1,128.5	1,075.1
Weight, Pounds	3,459.9	3,660.2	3,632.6	3,793.8	3,690.6
Periodicals					
Revenue	$ 2,215.1	$ 2,160.8	$ 2,191.8	$ 2,234.8	$ 2,164.9
Pieces, Number	9,022.6	9,070.0	9,135.3	9,319.9	9,689.8
Weight, Pounds	4,040.7	4,025.6	4,067.5	3,995.0	4,006.1
Express Mail					
Revenue	$ 918.1	$ 872.3	$ 852.8	$ 888.1	$ 910.5
Pieces, Number	55.9	55.5	54.1	55.8	61.3
Weight, Pounds	53.8	51.7	50.6	53.2	59.1
International Airmail					
Revenue *	$ 1,665.9	$ 1,630.5	$ 1,550.6	$ 1,441.0	$ 1,429.4
Pieces, Number *	774.3	829.0	817.9	775.3	865.2
Weight, Pounds *	203.0	185.2	168.4	152.6	151.8
International Economy Mail					
Revenue	$ 127.8	$ 134.3	$ 145.2	$ 145.9	$ 150.4
Pieces, Number	18.6	22.5	25.9	29.9	38.6
Weight, Pounds	54.2	56.6	60.3	60.5	65.3
Mailgrams * *					
Revenue	$ -	$ 0.8	$ 0.7	$ 1.2	$ 1.4
Pieces, Number	-	1.9	1.6	2.8	2.8
U.S. Postal Service					
Pieces, Number	1,015.9	621.3	529.3	391.6	424.9
Weight, Pounds	128.1	110.7	105.4	80.1	87.5
Free Matter for the Blind					
Pieces, Number	74.5	76.4	71.1	70.4	56.8
Weight, Pounds	35.4	34.4	34.6	29.8	28.1
Totals * * *					
Revenue	$ 69,144.0	$ 66,648.7	$ 65,868.7	$ 65,700.7	$ 63,761.1
Pieces, Number	213,137.7	211,742.7	206,105.6	202,184.7	202,821.9
Weight, Pounds	25,931.8	25,841.5	25,280.9	24,851.9	24,562.7

Operating Statistics

Category of Service		2006		2005		2004		2003		2002
(In millions of units indicated, unaudited)										
Registered Mail * * * *										
Revenue	$	72.8	$	77.2	$	75.0	$	82.1	$	86.6
Number of articles		7.1		7.7		7.4		8.2		9.1
Certified Mail * * * *										
Revenue	$	631.6	$	600.6	$	629.5	$	624.2	$	605.9
Number of articles		265.7		261.1		273.7		271.4		283.5
Insurance * * * *										
Revenue	$	136.7	$	132.2	$	127.8	$	138.3	$	135.2
Number of articles		52.8		53.6		53.2		59.1		59.8
Delivery Receipt Services * * * * *										
Revenue	$	610.1	$	569.2	$	538.0	$	503.1	$	460.4
Number of articles		1,018.8		953.8		840.6		748.8		535.5
Collect on Delivery										
Revenue	$	9.8	$	9.3	$	11.4	$	11.1	$	13.8
Number of articles		1.5		1.5		1.9		1.9		2.3
Money Orders										
Revenue	$	193.3	$	208.2	$	230.7	$	230.7	$	239.4
Face value of issues (non-add)	$	28,277.4	$	28,723.0	$	28,782.2	$	29,151.7	$	29,721.2
Number of articles		176.2		181.0		188.0		202.5		218.0
Other										
Box rent revenue	$	813.7	$	791.5	$	779.9	$	788.1	$	750.6
Stamped envelope and card revenue	$	25.2	$	21.0	$	21.9	$	24.4	$	29.3
Other revenue, net	$	914.2	$	740.3	$	676.8	$	395.8	$	333.3
Totals										
Special Services revenue	$	3,407.4	$	3,149.5	$	3,091.0	$	2,797.8	$	2,654.5
Mail revenue	$	69,144.0	$	66,648.7	$	65,868.7	$	65,700.7	$	63,761.1
Revenue Forgone	$	99.0	$	109.2	$	36.3	$	30.7	$	47.6
Total Operating Revenue	$	72,650.4	$	69,907.4	$	68,996.0	$	68,529.2	$	66,463.2

* Reclassification between Standard Mail and International Airmail in 2003.

* * Mailgram service has been discontinued

* * * Government agency and franked mail are included in their classes of mail, when using official mail.

* * * * Return receipts have been broken out from Registered Mail, Certified Mail and Insurance special service categories and reported in Delivery Receipt Services.

* * * * * Delivery Receipt Services contains Return Receipts for special services, Merchandise Return and Delivery Confirmation.

Operating Statistics

	2006	2005	2004	2003	2002
(Actual Numbers, unaudited)					
Career Employees					
Headquarters and HQ Related Employees *					
Headquarters * * *	2,761	2,654	2,708	1,867	1,712
Headquarters - Field Support Units * * / * * *	4,402	4,333	3,396	4,104	3,848
Inspection Service - Field	3,130	3,443	3,648	3,770	3,875
Inspector General	1,071	843	782	723	722
Total HQ and HQ Related Employees	11,364	11,273	10,534	10,464	10,157
Field Employees *					
Area Offices * *	1,395	1,420	2,196	2,205	2,107
Postmasters / Installation Heads	25,429	25,322	25,519	25,509	25,771
Supervisors / Managers	33,201	33,234	33,635	35,360	37,829
Professional Administration and Technical Personnel	8,539	8,945	9,168	9,436	9,661
Clerks	213,920	221,644	226,183	242,276	256,656
Nurses	166	167	167	171	173
Mail Handlers	57,158	56,028	54,769	56,776	59,259
City Delivery Carriers	224,400	228,278	228,140	229,404	233,639
Motor Vehicle Operators	8,715	8,689	8,628	8,778	9,092
Rural Delivery Carriers - Full Time	66,344	64,335	62,762	61,611	60,817
Building and Equipment Maintenance Personnel	39,986	39,893	40,263	41,469	42,275
Vehicle Maintenance Employees	5,521	5,488	5,521	5,576	5,513
Total Field Employees	684,774	693,443	696,951	718,571	742,792
Total Career Employees	696,138	704,716	707,485	729,035	752,949
Non-Career Employees *					
Casuals	22,518	19,182	20,529	17,373	19,065
Non-Bargaining Temporary	1,135	1,185	1,138	910	807
Rural Part Time: Subs / RCA / RCR / AUX	59,087	57,411	56,403	56,451	56,474
Postmaster Relief and Leave Replacements	12,188	12,046	12,157	12,161	12,234
Transitional Employees	5,133	8,460	9,884	11,025	12,847
Total Non-Career Employees	100,061	98,284	100,111	97,920	101,427
Total Employees	796,199	803,000	807,596	826,955	854,376

* Complement data from On-Rolls and Paid Employee Statistics database as of end of September 2003 - 2006 and early September 2002.

* * Beginning 2005 employees in the Sales organization were reported as Headquarters Related instead of in the Area Offices

* * * Beginning 2004, field employees performing headquarters functions were re-classified as Headquarters Related.

Operating Statistics

	2006	2005	2004	2003	
(In actual units indicated, unaudited)					
Post Offices, Stations and Branches					
Post Offices	27,318	27,385	27,505	27,556	2
Classified Stations, Branches and Carrier Annexes	5,557	5,622	5,623	5,796	
Contract Postal Units	3,014	3,116	2,889	2,777	
Community Post Offices	937	1,019	1,142	1,450	
Total Offices, Stations and Branches	36,826	37,142	37,159	37,579	3
Residential Delivery * / * *					
City Delivery Carriers	78,949,153	78,524,242	77,967,046	77,490,203	77,01
Rural	36,068,838	34,958,986	33,817,615	33,324,799	32,14
PO Box	15,615,744	15,614,801	15,634,610	15,730,694	15,77
Highway Contract	2,345,255	2,243,520	2,162,772	2,153,056	2,07
Total Residential Delivery	132,978,990	131,341,549	129,582,043	128,698,752	127,00
Business Delivery * / * *					
City Delivery Carriers	7,343,020	7,280,384	7,185,300	7,208,608	7,19
Rural	1,297,022	1,230,645	1,172,499	1,192,144	1,13
PO Box	4,490,102	4,412,559	4,321,862	4,203,433	4,06
Highway Contract	65,062	61,228	58,084	58,339	5
Total Business Delivery	13,195,206	12,984,816	12,737,745	12,662,524	12,45
Total Delivery Points	146,174,196	144,326,365	142,319,788	141,361,276	139,45
Change in Delivery Points	1,847,831	2,006,577	958,512	1,908,797	1,77

* 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.

* * FY 2003 - 2006 deliveries points are reported as of September 30th while 2002 reflects deliveries as reported in early to mid September.

Financial History Summary

(Dollars in millions)	2006	2005	2004	2003	2002
Statements of Operations					
Total revenue	$ 72,817	$ 69,993	$ 69,029	$ 68,764	$ 66,688
Total expense	71,917	68,548	65,964	64,896	67,364
Net income (loss)	**$ 900**	**$ 1,445**	**$ 3,065**	**$ 3,868**	**$ (676)**
Operating revenue	$ 72,551	$ 69,798	$ 68,960	$ 68,498	$ 66,415
Revenue foregone	99	109	36	31	48
Total operating revenue	72,650	69,907	68,996	68,529	66,463
Compensation and benefits	56,281	53,932	52,134	50,428	51,557
Other expenses	15,403	14,351	13,717	13,474	13,677
Total operating expenses	71,684	68,283	65,851	63,902	65,234
Income from operations	966	1,624	3,145	4,627	1,229
Interest and investment income	167	86	33	58	46
Interest expense deferred retirement	(231)	(263)	(103)	(116)	(1,601)
Other interest expense * *	(2)	(2)	(10)	(694)	(340)
Emergency preparedness, net	-	-	-	(7)	(10)
Net income (loss)	**$ 900**	**$ 1,445**	**$ 3,065**	**$ 3,868**	**$ (676)**
Balance Sheets					
Current assets *	$ 2,041	$ 1,933	$ 1,851	$ 3,607	$ 2,059
Property, equipment, and other assets * * *	26,447	23,065	22,858	23,419	56,735
Total assets	**$ 28,488**	**$ 24,998**	**$ 24,709**	**$ 27,026**	**$ 58,794**
Current liabilities *	$ 11,656	$ 9,206	$ 10,800	$ 16,753	$ 15,365
Other Liabilities *	10,556	10,416	9,978	9,407	39,131
Long-term debt	-	-	-	-	7,300
Equity	6,276	5,376	3,931	866	(3,002)
Total liabilities and net capital	**$ 28,488**	**$ 24,998**	**$ 24,709**	**$ 27,026**	**$ 58,794**
Changes in Net Capital					
Capital contributions of the U.S. Government	$ 3,034	$ 3,034	$ 3,034	$ 3,034	$ 3,034
Equity (deficit) since reorganization	2,342	897	(2,168)	(6,036)	(5,360)
Total beginning balance	5,376	3,931	866	(3,002)	(2,326)
Net income (loss)	900	1,445	3,065	3,868	(676)
Ending balance	**$ 6,276**	**$ 5,376**	**$ 3,931**	**$ 866**	**$ (3,002)**

* Certain reclassifications have been made to previously reported amounts.

* * 2003 Includes $360 million in debt repurchase expense.

* * * 2002 amount includes deferred retirement costs.

Selected Quarterly Financial Data

2006	Quarter 1	Quarter 2	Quarter 3	Quarter 4
(Dollars in millions, unaudited)				
Operating revenue	$ 18,498	$ 18,615	$ 17,835	$ 17,702
Total operating expenses	17,730	17,741	17,778	18,432
Income (loss) from operations	768	874	57	(730)
Other revenue (expense)	(40)	(28)	24	(25)
Net Income (Loss)	**$ 728**	**$ 846**	**$ 81**	**$ (755)**

2005	Quarter 1	Quarter 2	Quarter 3	Quarter 4
(Dollars in millions, unaudited)				
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 1	Quarter 2	Quarter 3	Quarter 4
(Dollars in millions, unaudited)				
Operating revenue	$ 18,209	$ 17,292	$ 16,591	$ 16,904
Total operating expenses	16,391	16,556	16,288	16,616
Income (loss) from operations	1,818	736	303	288
Other revenue (expense)	(1)	5	(44)	(40)
Net Income	**$ 1,817**	**$ 741**	**$ 259**	**$ 248**