Postal Rate Commission
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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, 2004 and 2003, and the related statements of operations, changes in net capital (deficiency) and cash flows for each of the three years in the period ended September 30, 2004. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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 financial position of the United States Postal Service as of September 30, 2004 and 2003 and the results of its operations and its cash flows for each of the three years in the period ended September 30, 2004 in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards,* we have also issued our report dated November 10, 2004 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. 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 10, 2004

statements of operations

(Dollars in millions)	Year ended September 30, 2004	2003	2002
Operating revenue	$68,996	$68,529	$66,463
Operating expenses:			
Compensation and benefits	52,134	50,428	51,557
Transportation	4,969	4,989	5,132
Other	8,748	8,485	8,545
Total operating expenses	65,851	63,902	65,234
Income from operations	3,145	4,627	1,229
Interest and investment income	33	58	46
Interest expense on deferred retirement obligations	(103)	(116)	(1,601)
Other interest expense	(10)	(334)	(340)
Debt repurchase expense	-	(360)	-
Emergency preparedness appropriations	-	177	179
Emergency preparedness expenses	-	(184)	(189)
Net income (loss)	$ 3,065	$ 3,868	$ (676)

See accompanying notes to financial statements.

balance sheets

(Dollars in millions)	September 30, 2004	2003
Liabilities and Net Capital		
Current Liabilities:		
Compensation and benefits	$ 2,640	$ 2,518
Estimated prepaid postage	1,256	1,349
Payables and accrued expenses:		
Commercial vendors and accrued expenses	1,739	2,146
Foreign countries	778	879
U.S. government	87	83
Total payables and accrued expenses	2,604	3,108
Customer deposit accounts	1,606	1,566
Outstanding postal money orders	767	768
Prepaid box rentals and other deferred revenue	397	387
Debt	1,800	7,273
Total Current Liabilities	11,070	16,969
Non-Current Liabilities:		
Workers' compensation costs	6,651	6,324
Employees' accumulated leave	2,006	1,932
Other	1,321	1,151
Total Non-Current Liabilities	9,978	9,407
Total Liabilities	21,048	26,376
Net Capital:		
Capital contributions of the U.S. government	3,034	3,034
Retained earnings (deficit) since reorganization	897	(2,168)
Total Net Capital	3,931	866
Total Liabilities and Net Capital	$24,979	$27,242

See accompanying notes to financial statements.

balance sheets

(Dollars in millions)	September 30, 2004	2003
Assets		
Current Assets:		
Cash and cash equivalents	$ 877	$ 2,266
Receivables:		
Foreign countries	621	744
U.S. government	327	359
Consignment	48	50
Other	139	144
Receivables before allowances	1,135	1,297
Less allowances	111	106
Total receivables, net	1,024	1,191
Supplies, advances and prepayments	220	366
Total Current Assets	2,121	3,823
Other Assets, Principally Revenue Forgone Appropriations Receivable	361	365
Property and Equipment, at Cost:		
Buildings	20,171	19,759
Equipment	17,277	17,166
Land	2,810	2,809
Leasehold improvements	1,103	1,060
	41,361	40,794
Less allowances for depreciation and amortization	20,656	18,717
	20,705	22,077
Construction in progress	1,792	977
Total Property and Equipment, Net	22,497	23,054
Total Assets	$24,979	$27,242

See accompanying notes to financial statements.

statements of changes in net capital (deficiency)

Year ended September 30, 2004, 2003 and 2002

(Dollars in millions)	Capital Contributions of U.S. Government	Retained Earnings (Deficit) Since Reorganization	Total Net Capital (Deficiency)
Balance, September 30, 2001	$3,034	$(5,360)	$(2,326)
Net loss	-	(676)	(676)
Balance, September 30, 2002	3,034	(6,036)	(3,002)
Net income	-	3,868	3,868
Balance September 30, 2003	3,034	(2,168)	866
Net income	-	3,065	3,065
Balance, September 30, 2004	$3,034	$ 897	$ 3,931

See accompanying notes to financial statements.

statements of cash flows

(Dollars in millions)	Year ended September 30, 2004	2003	2002
Cash flows from operating activities:			
Net income (loss)	$3,065	$3,868	$ (676)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	2,145	2,295	2,296
Loss on disposals of property and equipment, net	71	64	6
Decrease in other assets, principally revenue forgone appropriations receivable	4	3	4
Increase in workers' compensation liability	343	526	734
Increase (decrease) in employees' accumulated leave	74	(156)	(36)
Increase (decrease) in other non-current liabilities	170	(31)	196
Changes in current assets and liabilities:			
Decrease (increase) in receivables, net	167	(394)	(189)
Decrease (increase) in supplies, advances and prepayments	146	(39)	(7)
Increase (decrease) in compensation and benefits	106	(427)	(877)
Decrease in estimated prepaid postage	(93)	(151)	(123)
(Decrease) increase in payables and accrued expenses	(412)	1,201	(80)
Increase (decrease) in customer deposit accounts	40	(138)	145
Decrease in outstanding postal money orders	(1)	(218)	(2)
Increase in prepaid box rent and other deferred revenue	10	2	52
Net cash provided by operating activities	5,835	6,405	1,443
Cash flows from investing activities:			
Purchase of property and equipment	(1,685)	(1,314)	(1,705)
Proceeds from sale of property and equipment	26	37	30
Net cash used in investing activities	(1,659)	(1,277)	(1,675)
Cash flows from financing activities:			
U.S. government appropriations - Received	—	—	762
U.S. government appropriations - Expended	(92)	(177)	(179)
Issuance of debt	—	4,609	2,700
Payments on debt	(5,473)	(8,450)	(2,900)
Net cash (used in) provided by financing activities	(5,565)	(4,018)	383
Net (decrease) increase in cash and cash equivalents	(1,389)	1,110	151
Cash and cash equivalents at beginning of year	2,266	1,156	1,005
Cash and cash equivalents at end of year	$ 877	$2,266	$1,156

See accompanying notes to financial statements.

Notes to the financial statements

Note 1 - description of business

Nature of Operations

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

Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Almost 90% of our career employees are covered by collective bargaining agreements. The agreements with the major unions expire between November 20, 2005, and November 20, 2006.

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

Postal Reorganization

The Postal Service commenced operations on July 1, 1971, in accordance with the provisions of the Postal Reorganization Act (the Act). The equity that the U.S. government held in the former Post Office Department became the initial capital of the Postal Service. The Postal Service 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 1973 and 1982 totaled approximately $1.3 billion, resulting in total government contributions of approximately $3 billion. The U.S. government remained responsible for all the liabilities attributable to operations of the former Post Office Department. However, under the Balanced Budget Act of 1997, the remaining liability for Post Office Department workers' compensation costs was transferred to the Postal Service.

Although the Postal Service is excluded from the U.S. government budgetary process, the Postal Service enters into significant transactions with other government agencies, as disclosed throughout these financial statements.

Price Setting Process

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

Note 2 - summary of significant accounting policies

Basis of Accounting and Use of Estimates

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

Cash and Cash Equivalents

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

Current Values of Financial Instruments

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

We have foreign currency risk related to the settlement of terminal dues and transit fees with foreign postal administrations for international mail. The majority of our international accounts are denominated in special drawing rights (SDRs). The SDR exchange rate fluctuates daily based on a basket of currencies comprised of the euro, the Japanese yen, the pound sterling and the U.S. dollar. Changes in the relative

Notes to the financial statements

value of these currencies will increase or decrease the value of our settlement accounts and result in a gain or loss from revaluation reported in the results from operations. The actual currency used to settle accounts varies by country.

The impact on the statement of operations from this revaluation was a gain of $10 million in 2004, a loss of $9 million in 2003, and a loss of $7 million in 2002. In addition to the year end revaluation, we also recognize gains and losses on our payables and receivables when we settle with foreign postal administrations. The impact on the statement of operations from these settlement losses was $15 million in 2004, $12 million in 2003 and $7 million in 2002.

Supplies, Advances and Prepayments

Supplies, advances and prepayments are primarily composed of our inventories of supplies, motor vehicle parts and parts for mail processing equipment. We value our inventories at the lower of average cost or current market price. Total inventories amounted to $118 million at the end of 2004 and $123 million at the end of 2003.

Property and Equipment

We record property and equipment at what it cost us to acquire the assets, including the interest we pay on the money we borrow to pay for the construction of major capital additions. This interest amounted to $5 million in 2004, $1 million in 2003, and $23 million in 2002. Repairs and maintenance are charged to expense as incurred. This expense amounted to $744 million in 2004, $692 million in 2003 and $577 million in 2002.

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

Impaired Assets

We record losses on long-lived assets when events and circumstances indicate that the assets might be impaired. In accordance with Statement of Financial Accounting Standards (FAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* we have written down our impaired assets to the lower of cost or fair value. In 2004 it was 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 has been signed. This option is contingent on the Postal Service making all necessary repairs to the building. An impairment loss of $24 million was recorded in 2004 in order to reduce the carrying value of the property to its estimated fair value, including the cost of necessary repairs. No material impairments were recorded in 2003 or 2002.

Allowance for Doubtful Accounts

We provide an allowance for doubtful accounts in our outstanding receivables based on our collection history and an estimate of uncollectible accounts.

Revenue Recognition/Estimated Prepaid Postage

We recognize revenue when service is rendered. Estimated prepaid postage is the amount of cash we estimate that we collected by the end of the year for services that we will perform in the following year. In 2002 after extensive analysis, we changed our estimate of the sampling period for meter customers from 92 days to 30 days to more closely reflect the meter resetting practices of our customers. The impact of this change in estimate was a $113 million reduction of the liability in 2002.

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.

Segment Information

We operate in one segment throughout the United States and internationally. Our international operations are not significant.

Deferred Retirement Benefits and Costs

We are an independent establishment of the executive branch of the U.S. government. We provide pension benefits as defined by OPM and, therefore, have a parent-subsidiary type relationship. We account for our participation in the U.S. government sponsored retirement plans as a participant in a multi-employer plan arrangement in accordance with FAS 87, *Employers' Accounting For Pension Costs*. See notes 6 and 7 for additional information.

Notes to the financial statements

Retiree Health Benefits

We are required to pay a portion of the health insurance premiums of those retirees and their survivors who participate in the Federal Employees Health Benefits Program (FEHBP). We account for our participation in FEHBP as a participant in a multi-employer plan arrangement in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* Therefore, the costs of retiree health benefits are expensed as we incur them. See note 4 for additional information.

Workers' Compensation Costs

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

Our liability represents the estimated present value of the total amounts we expect to pay in the future for postal workers injured through the end of 2004. The estimate of the total costs 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, a net discount rate of -0.8% for medical expenses and 3.3% for compensation claims is used. During 2004 we changed these discount rates in order to more accurately reflect our liability. See note 3 for additional information.

Emergency Preparedness Appropriations

Emergency preparedness appropriations are the funds received from the federal government to help pay the costs to keep the mail, postal employees and postal customers safe. Upon receipt of the funds, we established a liability. In 2002 and 2003 we recognized these funds as non-operating revenue to the extent of the qualifying non-operating expenditure. Beginning in 2004 we are recognizing these funds as operating revenue to the extent they offset operating expenses. Appropriations utilized to purchase capital equipment will be offset against depreciation expense over the life of the equipment. See note 11 for additional information.

Reclassifications

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

Note 3 - workers' compensation

At the end of 2004, we estimate our total liability for future workers' compensation costs at $7,579 million. At the end of 2003 this liability was $7,236 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 $650 million. A decrease of 1% would increase our estimate of the liability by approximately $790 million.

In 2004, we recorded $1,239 million in workers' compensation expense, compared to the $1,473 million we recorded in 2003 and the $1,524 million we recorded in 2002.

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

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

In addition to the cost of workers' compensation claims, OWCP charges us an administrative fee for processing claims. In 2004, the administrative fee was $44 million, compared to $45 million in 2003 and $37 million in 2002.

Note 4 - health benefit programs

Career employees of the Postal Service are covered by the U.S. government health plan, the Federal Employees Health Benefits Program (FEHBP). The Office of Personnel Management administers the program and allocates the cost of the program to the various participating employers. Our

Notes to the financial statements

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. The employees of the Postal Service paid 16.7% of the cost in 2004, 2003 and 2002, and we paid the remainder.

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

We account for retiree health benefits as a participant in a multi-employer plan arrangement in accordance with FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* Our annuitant health benefit expenses amounted to $1,313 million in 2004, $1,133 million in 2003 and $987 million in 2002. We include these costs in our compensation and benefits expense.

Note 5 - debt and related interest costs

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

Cash outlays for interest (including the supplemental retirement obligations) were $242 million in 2004, $426 million in 2003 and $339 million in 2002.

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

At year-end, the current estimated market value of our debt was $1,800 million in 2004 and $7,283 million in 2003. Debt consists of $1,800 million in cash drawn on our line of credit with the FFB.

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

Our Debt Consists of the following

(Dollars in millions)

Interest Rate %	Terms*	September 30, 2004	2003
Notes payable to the Federal Financing Bank (FFB):			
1.167	Payable February 5, 2004	$ -	$2,000
1.195	Payable February 17, 2004	-	250
1.084	Floating rate; payable August 15, 2004	-	1,750
1.731**	Short-term, floating rate, revolving credit facility, final maturity date of May 6, 2005	1,800	3,273
		$1,800	$7,273

* All debt repurchasable at any time at a price determined by the current FFB rates.
** Weighted average interest rate; prior year's interest rate was 1.026%.

Note 6 - retirement programs

Our employees, retirees and their survivors participate in a pension program of the U.S. government. We account for our involvement in these programs as participation in a multi-employer plan arrangement, in accordance with FAS 87, *Employers' Accounting for Pensions.*

With certain exceptions, employees participate in one of the following three retirement programs based upon the starting date of their employment with the Postal Service. Employee and employer contributions are made to the Civil Service Retirement System, the Dual System or the Federal Employees Retirement System, which are administered by the Office of Personnel Management. Employees may also participate in the Thrift Savings Plan, which is a defined contribution retirement savings and investment plan. Postal Service employees are authorized to participate in the Thrift Savings Plan by the Federal Employees Retirement System Act of 1986. The Plan is administered by the Federal Retirement Thrift Investment Board.

Notes to the financial statements

Civil Service Retirement System (CSRS)

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

Dual Civil Service Retirement System/ Social Security System (Dual CSRS)

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

Federal Employees Retirement System (FERS)

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

Employer and employee base contributions, as a percentage of employee basic pay, are as follows for each of the three plans for 2004, 2003 and 2002:

	2004	2003	2002
CSRS			
Employer	17.4	17.4*	7.0
Employee	7.0	7.0	7.0
Dual CSRS			
Employer	18.0	18.0*	7.0
Employee	0.8	0.8	0.8
FERS			
Employer	10.7	10.7	10.7
Employee	0.8	0.8	0.8

* As of May 2003, P.L.108-18 changed our base contribution level for the CSRS. See note 7.

The number of employees enrolled in each of the retirement plans at the end of 2004, 2003 and 2002 is as follows:

	2004	2003	2002
CSRS	188,670	211,913	230,632
Dual CSRS	9,238	10,122	10,828
FERS	509,577	505,728	510,237

Deferred Retirement Liability – Civil Service Retirement System

Prior to Public Law 108-18 (see note 7), when we increased CSRS employees' current basic pay we were liable for the estimated additional deferred retirement liability. The Office of Personnel Management determined and billed us for the current portion of the increase in the estimated deferred liability of the Civil Service Retirement and Disability Fund (CSRDF) resulting from basic pay increases. We expensed as billed those amounts as they became payable in 30 equal annual installments, which included interest computed at a rate of 5% per year. We made the first payment at the end of the year in which employees received their pay increase.

Our retirement expense payment in 2002 under the CSRS as a result of basic pay increases was $1,393 million plus interest of $1,242 million.

Deferred Retirement Liability — Retirees' and Their Survivors' Cost of Living Adjustments (COLAs)

OPM determines the COLAs granted by Congress to our retirees. Under the Omnibus Budget Reconciliation Act of 1990, we were liable, by law, for our share of the COLAs granted to those retirees, and their survivors, retiring on or after July 1, 1971. We were not responsible for any costs due to federal civilian service before that date.

Prior to P.L.108-18 each year OPM determined the current portion of the increase in our share of the estimated liability of the CSRDF and billed us for COLAs granted for the current year. We expensed those billed amounts as they became payable in 15 equal annual installments, which included interest computed at a rate of 5% per year.

Our retirement expense payment in 2002 for our retirees' COLAs was $879 million plus interest of $359 million.

Notes to the financial statements

Expense Components

The following table lists the components of our total retirement expenses that are included in our compensation and benefits expense and related interest expense in the Statements of Operations for 2004, 2003 and 2002.

(Dollars in millions)	2004	2003	2002
CSRS	$1,641	$1,128	$ 740
FERS	2,255	2,172	2,121
FERS — Thrift Savings Plan	877	856	827
Dual CSRS	76	52	33
Social Security	1,610	1,544	1,511
Accrued Postal Supplemental Liability+	12	9	-
Interest expense on supplemental liability+	103	116	-
Amortization of deferred cost*:			
CSRS	-	-	1,393
Annuitant COLAs	-	-	879
Interest expense on deferred liabilities	-	-	1,601
Total retirement expense	$6,574	$5,877	$9,105

* Eliminated by P.L.108-18

+ Required by P.L.108-18

Employer cash contributions to retirement plans were $4,827 million in 2004, $4,031 million in 2003 and $6,013 million in 2002. These amounts do not include Social Security contributions and interest expense on deferred retirement liabilities.

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

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

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

During 2004, OPM estimated the present value of benefits at $191.1 billion, contributions at $15.9 billion, and plan assets at $171.7 billion. This resulted in a "supplemental liability" of $3.5 billion as of September 2003. This calculation assumed general salary increases of 4.0%, COLAs of 3.25% and interest of 6.25%, and is intended to provide for the "supplemental liability" over a 40-year period ending in September 30, 2043. Under the law OPM is not required to furnish the final actuarial calculation of the September 30, 2004, liability until June 30, 2005. OPM's calculation of the September 30, 2004, "supplemental liability" payment was $240 million.

OPM will recalculate the "supplemental liability", if any, on an annual basis. Each September 30, we will make any required payment resulting from this calculation.

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

Note 8 – revenue forgone

Our operating revenue includes accruals for revenue forgone. Revenue is forgone when Congress mandates that we provide free mail for certain mailers. Congress appropriates money to reimburse us for the revenue that we have forgone in providing these services. We have included as operating revenue the amounts appropriated by Congress for revenue forgone of $36 million for 2004, $31 million for 2003 and $48 million for 2002. Legislation enacted in 2003 and 2002 delayed payment of the amount authorized for 2004 and 2003 until the first day of 2005 and 2004, respectively. Accordingly, we have recorded these amounts as a receivable at year end.

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

Notes to the financial statements

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 amounts receivable as of September 30, 2004 and 2003, were $364 million and $367 million, respectively.

Note 9 - commitments

At September 30, 2004, we estimate our financial commitment for approved capital projects in progress to be approximately $2,808 million.

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

(Dollars in millions)	2004	2003	2002
Non-cancellable real estate leases including related taxes	$ 896	$ 923	$ 894
Facilities leased from General Services Administration subject to 120-day notice of cancellation	49	53	45
Equipment and other short-term rentals	213	201	214
Total	$1,158	$1,177	$1,153

At September 30, 2004, our future minimum lease payments for all non-cancellable leases are as follows:

Year (Dollars in millions)	Operating	Capital
2005	$ 823	$ 76
2006	799	76
2007	761	76
2008	712	76
2009	658	76
2010	605	76
After 2010	5,283	472
	$9,641	$928
Less: Interest		234
Total capital lease obligations		694
Less: Short-term portion of capital lease obligations		42
Long-term portion of capital lease obligations		$652

Most of these leases contain renewal options for periods ranging from 3 to 20 years. Certain non-cancellable real estate leases give us the option to purchase the facilities at prices specified in the leases.

Capital leases included in buildings were $847 million in 2004 and $963 million in 2003. Total accumulated amortization is $259 million in 2004 and $259 million in 2003. Amortization expense for assets recorded under capital leases is included in depreciation expense.

Note 10 - contingent liabilities

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

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

Notes to the financial statements

As a part of our continuing evaluation of estimates required in the preparation of management's financial statements, we recorded a $104 million decrease in the contingent liabilities balance in 2004, compared to a decrease of $92 million in 2003 and a $187 million increase in 2002. We recognized settlements, payments and changes in estimates of claims and lawsuits in our changes in contingent liabilities. Management and General Counsel believe that we have made adequate provision for the probable amounts due under the suits, claims and proceedings we have discussed here.

Note 11 - emergency preparedness funding

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

In 2002 and 2003, the majority of our emergency preparedness expenses were for one-time activities, such as plant decontamination. We recognized these expenses as non-operating expenses and the corresponding revenue offset as non-operating revenue. Due to the ongoing nature of the remaining expenses, such as depreciation, supplies, and maintenance, beginning in 2004 all emergency preparedness items are treated as operating expenses and the associated revenue as operating revenue.

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

(Dollars in millions)	2004	2003	2002
Operating expenses:			
Personnel costs	$ 9	$ 12	$ 73
Non-Personnel Costs	123	-	-
Total operating expenses	132	12	73
Non-operating expenses	-	184	189
Total Expenses	$ 132	$196	$262
Capital Equipment Commitments	$ 222	$189	$ 38

As of September 30, 2004, all emergency preparedness appropriations have been fully expended or committed. We recognize these appropriations as revenue in the year in which the related expenditure is recognized as an expense, or when the government approves the reimbursement of a previously incurred expense. The emergency preparedness appropriations revenues recognized during the years ended September 30 were $92 million in 2004, $177 million in 2003 and $179 million in 2002. They are reflected in the 2004 and 2003 Statements of Cash Flows as a financing activity.

The capital funds spent in 2002 ($38 million) were spent on irradiation equipment that did not meet our needs. With the approval of OMB, the eight machines valued at $24 million were transferred to other government and public agencies, and the manufacturer provided us with a stronger machine at no additional cost. This new machine is valued at $14 million and is not yet deployed.

Appropriations that had not been recognized as revenue as of September 30, 2004 and 2003, were $314 million and $406 million, respectively. The balance was recorded as an accrued expense until spent. Amounts spent on capital equipment are deferred as a non-current liability and amortized to offset depreciation expense of the related equipment.