UNITED STATES POSTAL SERVICE

INTEGRATED FINANCIAL PLAN FY 2007

OPERATING PLAN

CAPITAL PLAN

FINANCING PLAN

PREFACE

The United States Postal Service Integrated Financial Plan (IFP) for Fiscal Year (FY) 2007 has been developed by management and is hereby submitted to the Board of Governors.

This annual planning document provides the Board the primary input of the Postal Service's estimated business needs and results as they regularly review, evaluate and decide upon issues relating to the organization's financial condition and operations during the year.

The IFP integrates three distinct annual plans, namely the Operating Plan, the Capital Plan and the Financing Plan. Each of these plans has been developed using FY 2006 forecasted operating results as a starting point, and each is dynamically linked to another. These plans were developed under a four phase management cycle: Establish, Deploy, Implement and Review. The Establish Phase, which included setting organizational indicators and targets for the fiscal year, began in December 2005. The Deploy Phase, calling for plans to achieve the targets and allocate resources, began in March 2006. The Implementation Phase will begin with the new fiscal year and the Review Phase is ongoing. The Capital Plan allocates funds for construction and purchase of facilities and equipment that will improve service, generate productivity and improve financial performance. For FY 2007 these investments are planned to be funded by cash flows generated from operations. Short-term borrowing will be required; however, average debt outstanding during the year will be minimal.

TABLE OF CONTENTS

EXECUTIVE SUMMARY

The FY 2007 Integrated Financial Plan (IFP) consists of an Operating Plan with $1.7 billion in net income and operating cash flow of $4.0 billion; a Capital Plan that commits $3.5 billion to achieve improved service, cost reductions, productivity, and infrastructure improvements. Capital spending is planned to amount to $2.2 billion, which is in line with depreciation expense.

There are potentially more risks in the achievement of this plan compared to recent years. The plan assumes a May 6, 2007 implementation of the 8.5 percent average postage rate increase currently pending at the Postal Rate Commission (PRC). Any differences in the amount or the implementation date of the rate case will change the revenue and volume projections contained in this plan.

FY 2007 Financial Summary

		FY 2006 Estimate	FY 2007 Plan
	Revenue	$72.9	$75.3
–	Expense	71.7	73.6
=	Net Income	$1.2	$1.7
+	Depreciation	2.1	2.2
+	Adjustments	0.6	0.1
=	Cash Flow From Operations	$3.9	$4.0
+	Capital Cash Outlay	(2.4)	(2.2)
=	Free Cash Flow	$1.5	$1.8
+	Cash From Financing	1.9	1.2
=	Change in Cash	3.4	3.0
	End of Year Cash	$1.3	$1.0
+	Restricted Cash – Escrow	3.0	6.3
=	Total Cash on Hand	$4.3	$7.3
	Net Deficiency After Escrow	$(1.8)	$(1.6)
	Debt Outstanding at Year End	$1.9	$3.1
	Average Debt Outstanding During Year	$0.0	$0.2

($ Billions)

Personnel costs are 78 percent of the Postal Service's total expenses. Labor negotiations with the four largest unions will take place this fall, as current contracts with the National Association of Letter Carriers, AFL-CIO (NALC), American Postal Workers Union, AFL-CIO (APWU), National Rural Letter Carriers' Association (NRLCA), and the National Postal Mail Handlers Union (NPHMU) all expire on November 20, 2006. The labor assumptions in this plan are consistent with those in the R2006-1 rate case, one percent less than the forecasted change in the Employment Cost Index (ECI). If the outcome of the labor negotiations differs from this forecast, the net income assumption for FY 2007 could change significantly.

The forecast assumptions in the plan are for continued growth in the economy. The plan assumes that fuel prices will increase, although not at the rate experienced in the last two years. It includes continued aggressive workhour reductions as automation is deployed and processes improved to achieve better service and productivity. Finally, the plan does not attempt to estimate financial impacts from potential passage of postal legislation. All of these issues are discussed further in upcoming sections of the plan.

Operating Plan - Revenue

The FY 2007 revenue of $75.3 billion is a planned increase of $2.4 billion over the previous year, or 3.2 percent, due to the carryover of the January 2006 rate increase along with the anticipated May 2007 rate increase.

Operating Plan - Expense

Total FY 2007 expense of $73.6 billion is a planned increase of $1.9 billion or 2.6 percent, over FY 2006. Operating expense growth is restrained due to $1.1 billion in planned cost reduction actions, consistent with the Strategic Transformation Plan.

Net Income
The FY 2007 operating plan results in net income of $1.7 billion prior to funding the estimated $3.3 billion escrow requirement. The escrow amount cannot be recognized as expense under generally accepted accounting principles (GAAP), although the escrow is treated as an expense for the postage rate making process.

Escrow Requirement
The Postal Civil Service Retirement System Funding (CSRS) Act of 2003 (Act) was signed into law by the President on April 23, 2003. This Act, PL 108-18, changed the Postal Service funding requirements for CSRS retiree benefits and the related payment schedules. The Office of Personnel Management (OPM) projected that without this reform the Postal Service had over-funded its pension obligations and, ultimately, would do so by $105 billion over the life of the system. The Act refers to these averted overpayments as "savings", which the Act defines as the difference between contributions the Postal Service would have made if this Act had not been enacted and the contributions made by the Postal Service under the Act. As directed by the Act, the Postal Service used the "savings" in 2003, 2004, and 2005 to reduce outstanding debt to the U.S. Treasury and hold postage rates steady until 2006. Additionally, PL 108-18 requires "to the extent that such savings are attributable to any fiscal year after fiscal year 2005, shall be considered to be operating expenses of the Postal Service and, until otherwise provided for by law, shall be held in escrow and may not be obligated or expended."

Capital Plan
The FY 2007 capital commitment plan totals $3.5 billion and reflects the priorities outlined in the Strategic Transformation Plan. Capital commitments will be targeted toward projects that provide improved service, a high return on investment, and handle necessary infrastructure needs. Many of the planned projects will require Board approval prior to execution. These commitments will result in a multi-year stream of cash outlays.

Financing Plan
The projected $3.9 billion FY 2006 cash flow from operations will finance capital cash outlays of $2.4 billion and contribute $1.5 billion toward the FY 2006 escrow requirement of $3.0 billion. Short-term year-end borrowing of $1.9 billion will be required.

In FY 2007, cash flow from operations of $4.0 billion will finance $2.2 billion in capital cash outlays and provide $1.8 billion toward the year's estimated escrow requirement of $3.3 billion. Short-term year-end borrowing will again be required, in the amount of $1.2 billion. At the end of FY 2007, the amount of funds in escrow is expected to be $6.3 billion. This does not include projected interest income of $158 million on the FY 2006 escrow, which is accounted for in the income and debt flow statements.

Consistent with established practice, on the first day of FY 2007, the Postal Service will apply all available unrestricted cash to debt reduction and operate with a minimized cash balance thereafter.

ASSUMPTIONS AND UNCERTAINTIES

The Economy

The economic data and forecasts that underlie the Integrated Financial Plan were developed by Global Insight Inc., a respected and independent economic forecasting firm.

The Postal Service used Global Insight's most recent baseline forecast, which estimates that growth in the FY 2007 Gross Domestic Product will moderate from FY 2006 levels. Growth in retail sales and nonfarm employment, both key drivers of mail volume growth, will also abate. The reduction in growth in these economic drivers, as well as an assumed 8.5 percent postal rate increase implemented on May 6, 2007, will all tend to slow volume and revenue growth.

Economic Assumptions

	FY 2006	FY 2007
Gross Domestic Product (% Growth)	3.4%	2.7%
Retail Sales (% Growth)	3.8%	1.4%
Nonfarm Employment (% Growth)	1.6%	1.4%
Consumer Price Index (% Growth)	3.6%	2.1%

Source: Global Insight, Inc. – July Baseline Forecast

Increases in mail volume and related Postal Service revenue depend on the demand for postal services, which in turn depends on a variety of factors including economic growth, electronic diversion, and the attractiveness of competitive alternatives. On the basis of these economic assumptions and the projected May 2007 rate increase, FY 2007 mail volume is projected to decline 0.5 percent from the FY 2006 forecasted levels. All mail classes are projected to decrease except Standard Mail, which is projected to increase 1.9 percent.

The slowdown in overall economic growth is not unanticipated. In its monthly meetings, the Federal Reserve raised its target federal funds rate 17 consecutive times until pausing in August 2006. These increases have contributed to lethargic growth in a number of sectors of the economy, particularly in those affected by the slowdown in residential home sales.

The federal funds rate increases occurred as energy prices reached unprecedented levels. Uncertainties regarding oil production and refinement have contributed to both the high level of fuel prices and uncertainty regarding the economy. Supply disruptions both real and feared have added to upward pressure on oil prices caused by increased demand from rapidly-growing Asian economies, particularly China. In addition to directly increasing postal transportation costs and utility bills, increases in the Consumer Price Index (CPI) are passed through to postal wages through contractual cost-of-living adjustments (COLAs).

Postal Reform Legislation

Due to the differences in versions of postal legislation passed by the House and Senate, management has developed this plan based upon current law, and consistent with GAAP. Should legislation be enacted, the plan could be impacted.

Rate Case R2006-1

This plan assumes that the PRC issues a recommended decision on the current R2006-1 rate case that will provide an average 8.5 percent rate increase as requested by the Postal Service in time to implement in May, 2007. Variations in either the amount of the rate increase or the timing of its implementation will change volume, mix and revenue projections contained in this plan.

Labor Negotiations

Labor negotiations with the four largest unions will take place this fall, as current contracts with the National Association of Letter Carriers, AFL-CIO (NALC), American Postal Workers Union, AFL-CIO (APWU), National Rural Letter Carriers' Association (NRLCA), and the National Postal Mail Handlers Union (NPMHU) all expire on November 20, 2006. The plan assumes that negotiations will result in labor cost increases of one percent less than the Employment Cost Index (ECI), consistent with the rate filing before the PRC. Variances from this assumption, either through collective bargaining or legally mandated arbitration, could affect financial results for the year.

Workhour Reductions

The FY 2007 plan reduces workhours by 40 million below the estimated FY 2006 level, while providing universal service to a continuously expanding delivery network. The planned workhour reductions will be challenging and will continue to rely on development and implementation of process improvements and capital investment program savings.

INTEGRATED FINANCIAL PLAN
FISCAL YEAR 2007

OPERATING PLAN

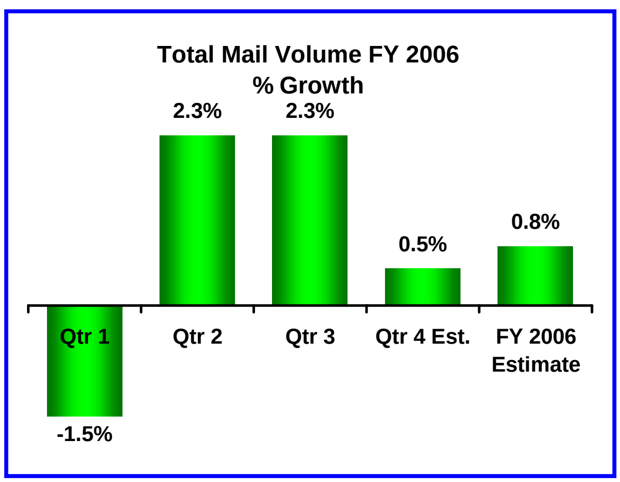
The FY 2007 planned net income is $1.7 billion, which is an increase of $0.5 billion from FY 2006 before the escrow requirement.

FY 2007 Operating Budget	FY 2006 Estimate	FY 2007 Plan	Change	% Change
Revenue	$ 72,920	$ 75,273	$ 2,353	3.2%
Expense	71,688	73,564	1,876	2.6%
Net Income	$ 1,232	$ 1,709	$ 477	
Escrow – Restricted Cash	3,015	3,285	270	9.0%
Deficiency after Escrow	−$ 1,783	−$ 1,576	$ 207	
($ Millions)				

The operating plan allocates resources to meet established goals and provides cash flow from operations to finance capital investments and contribute to the $3.3 billion escrow requirement. The FY 2007 plan calls for a revenue increase of 3.2 percent and an expense increase of 2.6 percent, which includes planned cost reductions of approximately $1.1 billion in line with the Postal Service's transformation plan strategies.

FY 2006 BASELINE ESTIMATES

Using actual data for the first three quarters, FY 2006 volume is projected to increase 0.8 percent or 174 million pieces over FY 2005. After decreasing 1.5 percent in the first quarter, volume grew 2.3 percent in quarters two and three. The estimate of 0.5 percent volume growth in the fourth quarter is driven by assumptions that oil prices, interest rates, and economic uncertainty will negatively impact the use of the mail.



Advertising mail continues to increase in importance. For the second consecutive year, Standard Mail volumes exceeded First-Class Mail volumes. Standard (excluding non-profit) Mail volumes grew nearly 2.2 billion pieces (2.5 percent) while First-Class Mail lost 0.5 billion pieces (0.5 percent). Within First-Class Mail, workshared letters, which contains increasing amounts of advertising grew 0.7 billion pieces (1.4 percent). These gains were more than offset by a 1.2 billion piece (2.9 percent) reduction in single piece letter volume. First-Class letter mail of all types continues to be adversely challenged by electronic competition.

Priority Mail volume is projected to grow nearly 4 percent in FY 2006 and Express Mail volume is projected to grow 1.5 percent. These two products are benefiting from several factors. Postal marketing strategies emphasizing ease of use (such as Click-N-Ship, carrier pickup, the Priority Mail flat rate envelope and the Priority Mail flat rate box) are making it easier for customers to use these products. Competitors' surcharges, most notably for fuel costs, have made postal prices increasingly competitive. Parcel Post volume is projected to decline due to changes within the package industry.

Total revenue is projected to increase $2.9 billion or 4.2 percent in FY 2006 over the previous year, largely driven by the 5.4 percent rate increase in January 2006. The Postal Service continues to see downward pressure on revenue per piece caused by the shift from full rate First-Class Mail to low yield products such as Standard Mail and workshared letters.

FY 2007 Volume and Revenue Plan

Overall mail volume is expected to decrease by 1.2 billion pieces or 0.5 percent in FY 2007. The Postal Service expects to raise rates an average of 8.5 percent in May 2007. These increases will serve to raise additional revenues but could also slow volume growth. The volume and revenue projections used herein are based on the same rate assumptions as were used in the Docket Number R2006-1 omnibus rate case.

Volume

	FY 2006 Estimate	FY 2007 Plan	Change	% Change
First-Class Mail	97,546	94,775	−2,771	−2.8%
Priority Mail	923	887	-36	−3.9%
Express Mail	56	52	−4	−7.8%
Periodicals	9,020	8,780	−240	−2.7%
Standard Mail	102,763	104,721	1,958	1.9%
Package Services	1,185	1,172	−13	−1.1%
International	862	827	−35	−4.0%
Other*	1,126	1,098	−28	−2.5%
Total	213,481	212,312	−1,169	−0.5%
(Pieces in millions)				

* Postal volume and Free Mail for the Blind and Handicapped are included in the Other category

First-Class Mail volume is expected to decline 2.8 percent in FY 2007. This decrease reflects the fact that First-Class rates are assumed to increase by 7.2 percent, as well as continuing shifts to electronic alternatives. Priority Mail is expected to lose 3.9 percent of its volume, mostly due to a 13.8 percent rate increase. Express Mail is expected to have the largest percentage decrease in volume (7.8 percent). This reflects the fact that Express Mail rates are assumed to increase 12.5 percent and that Express Mail is the most price sensitive product. A 2.7 percent decline is projected for Periodical Mail volumes. This decline is the result of an assumed rate increase of 12.4 percent and the long-term trend of circulation declines. Standard Mail volume is expected to increase 1.9 percent despite an assumed rate increase of 9.3 percent. This will be the lowest growth rate in Standard since FY 2002. With a rate increase of 13.3 percent Package Services volume is expected to decrease 1.1 percent. International mail volume is expected to decline slightly for the first time since FY 2003, due to rate increase elasticity and discontinuation of low margin products.

Revenue

	FY 2006 Estimate	FY 2007 Plan	Change	% Change
First-Class Mail	$ 37,035	$ 37,282	$ 247	0.7%
Priority Mail	5,027	5,155	128	2.5%
Express Mail	923	904	−19	−2.1%
Periodicals	2,214	2,309	95	4.3%
Standard Mail	19,965	21,452	1,487	7.4%
Package Services	2,264	2,386	122	5.4%
International	1,883	1,986	103	5.5%
Other*	3,609	3,799	190	5.3%
Total	$ 72,920	$ 75,273	$ 2,353	3.2%
($ millions)				

* Special Services, Investment Income and Appropriations are included in the Other category

The projections of FY 2007 volumes and revenues are based on estimates of FY 2006 results; actual FY 2006 results may differ.

Delivery Network

The Postal Service delivery network is projected to increase by 1.9 million delivery points in FY 2006. The same level of increase is projected for FY 2007. Most of the growth continues to be in deliveries by rural carriers.

Delivery Growth

	FY 2006 Growth	% Change
City Carrier Deliveries	493	0.6%
Rural Carrier Deliveries	1,177	3.3%
Contract Delivery Services	98	4.3%
Post Office Boxes	90	0.4%
Total	1,858	1.5%
(Deliveries in thousands)		

Expenses By Budget Category

Total expenses are budgeted at $73.6 billion; an increase of 2.6 percent above FY 2006 estimated expenses. The FY 2007 expense plan continues the unprecedented productivity improvements achieved each year since 2001. The following table details expenses by budget category.

FY 2007 Expenses By Budget Category

	FY 2006 Estimate	FY 2007 Plan	Change	% Change
Field Operations	$ 61,362	$ 62,921	$ 1,559	2.5%
Corporate Transportation	3,478	3,607	129	3.7%
Headquarters (HQ) Administrative*	1,412	1,414	2	0.0%
Programs/Corporate-wide Activities	2,164	2,194	30	1.4%
Servicewide	2,889	2,993	104	3.6%
Office of the Inspector General (OIG)*	158	208	50	31.6%
Postal Rate Commission (PRC)	10	11	1	15.3%
Interest & CSRS Liability	215	216	1	0.5%
Total	$71,688	$73,564	$1,876	2.6%
($ Millions)				

**304 positions shifted from the Inspection Service (HQ Administrative) to OIG.*

Field Expenses

Field expenses are projected to increase by $1.6 billion, or 2.5 percent, in FY 2007. This increase is largely driven by change in the cost per workhour resulting from cost-of-living adjustments (COLAs), general wage increase carryover, and health benefit premium increases. The carryover impacts of the March 2006 and September 2006 COLAs alone will be $796 million in FY 2007, which is 1.8 percent of projected bargaining unit salary costs. Projected increases in fuel costs also contribute to the overall increase in field expenses. The projected growth in field costs has been offset significantly by a number of cost reduction programs. Specifics of cost reductions are presented in the Cost Reduction Programs section.

Corporate Transportation Expenses

The FY 2007 plan anticipates corporate transportation expense of $3,607 million, a 3.7 percent increase over FY 2006. The major driver of rising transportation expenses is the scheduled escalation in the contractual transportation costs and increases driven by fuel costs. These are partially offset by operational efficiency improvements of $138 million.

Headquarters Administrative Expenses

Headquarters administrative expense includes headquarters organizations, field support units, and the Postal Inspection Service. Headquarters administrative costs are projected to remain at nearly the same level as the prior year, due in part to the workload shift from the Inspection Service to the Office of the Inspector General.

Programs and Corporate-wide Activities Expense

Programs and Corporate-wide Activities serve as a centralized control for corporate activities performed throughout the Postal Service. The majority of these activities directly support field operations. They are managed centrally so as to leverage the efficiencies of scale and provide management with transparency into the costs and returns for providing these key support services. Corporate-wide Activities and Programs are budgeted at $2.2 billion in FY 2007, which is 1.4 percent above the estimate for FY 2006. The table lists the largest expense programs and is followed by a discussion of the major changes in these program budgets.

FY 2007 Program Spending
Major Program Impacts

Program	FY 2006 Estimate	FY 2007 Plan	Change	% Change
Mail Transportation Equipment Service Ctrs	$212	$189	($23)	−11.1%
Debit/Credit Card Fees	135	152	17	12.6%
Corporate Advertising	125	112	(13)	−10.3%
Human Capital Enterprise/HR Shared Svcs.	70	107	37	52.9%
Stamp Manufacturing	98	99	1	0.7%
Expedited Supplies	98	98	0	−0.2%
Mail Transportation Equipment	118	85	(33)	−27.7%
Corporate Contact Management	78	84	6	8.0%
Point of Service	104	81	(23)	-22.8%
Advanced Computing Environment	58	75	17	28.8%
Telecommunicats/Network Operations	86	66	(20)	-23.3%
All Other Programs	982	1,046	63	6.5%
Total All Programs	$2,164	$2,194	$30	1.4%

($ Millions)

Program Increases

The Postal Service's second largest expense program is the payment of **Debit and Credit Card** fees to card companies. Although the Postal Service has negotiated lower transaction fees in recent years, the use of debit and credit cards in postal transactions has been increasing at double digit rates for the last several years. With the expansion of alternate revenue channels such as **Click-N-Ship** and **Automated Postal Centers**, this trend is expected to continue.

The **Human Capital Enterprises/HR Shared Services Program** – now called **Postal People**, plans a significant increase in spending in 2007 to substantially complete the replacement of the legacy human resources systems and processes with a more modern and efficient shared services system. The increase in expenses in 2007 results from the national implementation and concurrent ramp-up of hiring in the Greensboro Service Center. The benefits of this program are included in other expense categories.

The **Advanced Computing Environment** is centralizing more of the computing and printing processes. Provisions have also been included in the 2007 plan for the replacement of some aging hardware, which was deferred from 2006.

Program Decreases

The **Mail Transportation Equipment Service Center** (contracted) sites account for the largest single program expense. These are sites where mail transport equipment is processed, repaired and stored and then distributed to internal and external customers. The Postal Service has reexamined MTESC operations and the plan includes $23 million in cost reductions and efficiencies.

The purchasing of **Mail Transportation Equipment** is a centralized function for acquiring all new rolling containers, sacks, trays, lids, and pallets to contain all classes of mail for processing, transporting, and delivering. The FY 2007 budget for these programs was significantly reduced as a result of a redesigned Material Distribution and Inventory Management System (MDIMS), better demand forecasting, inventory reduction, and order shortage reduction.

Corporate Advertising is aimed at enhancing revenue growth for Postal Service products and services. The FY 2007 plan refocuses the advertising efforts for less expense.

The FY 2007 plan for **Point of Service** has been reduced by capturing the efficiencies of transitioning to a single-vendor solution.

Servicewide Expenses

Servicewide expenses are national-level controlled expenses that are not charged to individual operating or administrative units.

The largest component of this category, retiree health benefits, is projected to increase by 11.0 percent or $180 million to a total of $1.8 billion in FY 2007 and accounts for the entire increase in this category. The increase is driven by continued increases in premiums, and growth in the number of retirees and survivors covered.

In addition, Emergency Preparedness Programs (EPP) account for $152 million of planned FY 2007 servicewide expenses. The majority of EPP expenses are for the purchase of consumable cartridges and logistics support for the Biohazard Detection Systems (BDS). The EPP expenses are essential components of the Postal Service's safety system for the protection of postal employees and the public from biological agents that could be introduced into the mail stream.

Office of the Inspector General (OIG) and the Postal Rate Commission (PRC)

The budgets of the OIG and the PRC are developed by those organizations and are not subject to the control of postal management. The FY 2007 plan for the OIG calls for expenses of $208 million. A significant portion of this increase is attributable to the increased staffing required after the transfer of certain investigative responsibilities from the Postal Inspection Service.

EXPENSES BY COMPONENT

Examining expense growth by component provides another perspective on the FY 2007 Operating Plan as reflected in the following chart. The FY 2007 plan projects that personnel expense, including salaries, employee and retiree benefits, and workers' compensation, will increase by $1.3 billion, or 2.4 percent. Employee costs represent 78 percent of the USPS total cost.

This growth in personnel expense is being offset to a significant extent by planned reductions in workhours. The major drivers of the personnel expense increase include change in the cost per work hour resulting from cost-of-living adjustments (COLAs), general wage increase carry-over, and health benefit increases. Health insurance premiums are assumed to increase by 7 percent for current employees in January 2007. Health benefits expense of $7.1 billion, for current employees and retirees, accounts for 9.7 percent of total FY 2007 expense.

FY 2007 Expenses By Component

	FY 2006 Estimate	FY 2007 Plan	Change	% Change
Personnel	$ 56,045	$ 57,366	$ 1,320	2.4%
Non-Personnel	9,372	9,723	351	3.7%
Transportation	6,056	6,259	203	3.4%
Interest & CSRS Liability	215	216	1	0.5%
Total Expenses	$71,688	$ 73,564	$ 1,876	2.6%
($ Millions)				

Non-personnel expenses consist of a wide variety of national, field and headquarters costs. These include purchased services, utilities, rent, vehicle maintenance, and depreciation. Their projected growth in FY 2007 is primarily due to projected inflationary costs. Total transportation costs are expected to grow approximately $203 million. Substantially all of that increase is attributable to projected fuel cost increases, compared to the levels of early FY 2006.

CONTINUED WORKHOUR REDUCTIONS

The FY 2007 plan reduces workhours by 40 million from the estimated FY 2006 total in spite of adding 1.9 million delivery points. The FY 2007 planned workhour reduction target is equal to approximately 20,000 full-time equivalent employees. The workhour reductions are a product of process improvements, capital investment programs, and a projected volume decline. The FY 2007 workhour plan follows seven consecutive years of productivity improvements.

COST REDUCTION PROGRAMS

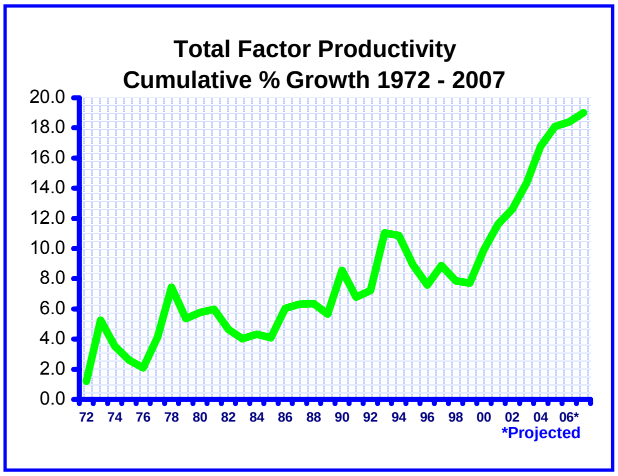
The initiatives which enable the workhour and cost reductions totaling $1.1 billion in the FY 2007 plan are detailed in the table. Operational efficiency benefits are spread across all functions, including transportation and headquarters. These initiatives employ several programs and productivity initiatives; process improvements, implementing best practices, standardization, consolidation of processing operations, complement management, and out-sourcing work activity. Previously approved capital investment programs are projected to provide cost reductions totaling $537 million, primarily from automation improvements, reduced manual processing operations and increased machine utilization and efficiency.

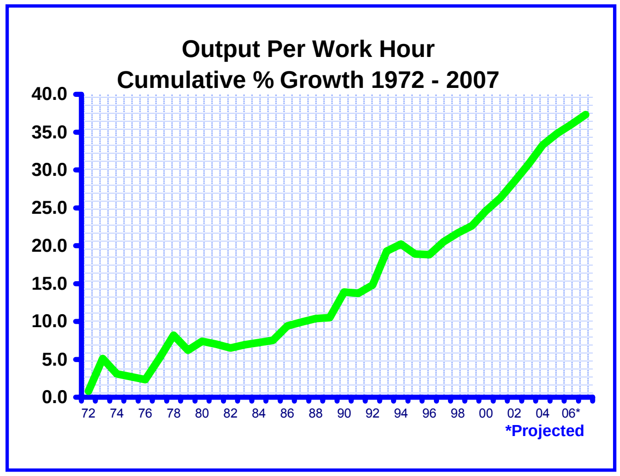
FY 2007 Cost Reduction Overview

Activity	Savings
Operational Efficiency Gains (Including BPI)	$ 347
Network Transportation	138
Dedicated Air Carrier Savings	92
	$ 577
Capital Investments:	
Automated Package Processing System (APPS)	$ 101
Postal Automated Redirection System (PARS)	75
OCR Enhancements for Letter Automation	73
Integrated Dispatch & Receipt Program	60
Automatic Induction Systems for AFSM 100	48
Human Resources Shared Services	48
Automated Postal Centers (APC)	36
Automatic Tray Handling for AFSM 100	30
Surface Visibility	14
All Others (16 programs range $100K to $8M)	52
Total Reductions From Capital Investments	$ 537
Total Cost Reductions	$ 1,114
($ Millions)	

PRODUCTIVITY

Total Factor Productivity (TFP) measures the change in relationship between outputs (workload) and all resources used in producing those outputs, including labor, materials, and capital. Output per Workhour measures the change in the relationship between outputs, or workload (mail volume and deliveries), and the labor resources used in producing those outputs. TFP is projected to grow 0.5 percent in FY 2006 over the previous year and Output per Workhour is estimated to increase 1.4 percent. FY 2006 marks the seventh consecutive year of positive TFP growth. The following charts show the cumulative growth in Output per Workhour and Total Factor Productivity from the date of Postal Reorganization through the projection for FY 2007. In that time, TFP and Output per Workhour will have grown 19.0 percent and 37.3 percent, respectively.





While productivity increases in FY 2006 were driven by absorbing workload growth, productivity increases in FY 2007 will be achieved by reducing resource usage well beyond the reduction in total workload. Achieving the FY 2007 Integrated Financial Plan will result in a 0.6 percent increase in TFP and a 1.3 percent Output per Workhour growth rate, an eighth straight year of positive TFP.

CAPITAL INVESTMENT PLAN

FY 2006 CAPITAL COMMITMENTS

The capital commitments in FY 2006 are estimated at $1.9 billion. Noteworthy projects approved in FY 2006 are:

- Purchase of the Automated Flat Sorting Machine (AFSM) 100 Automatic Induction Phase 2, which is a modification to an existing AFSM 100 that replaces manual flat mail preparation activities with mechanized preparation, transport, and loading;

- Additional Delivery Bar Code Sorter (DBCS) equipment includes 211 new DBCS VI machines and 797 stacker modules for existing Phase II-V DBCS machines. The additional equipment will increase the amount of letter mail processed in automated operations and provide labor savings in manual sorting operations;

- The Northeast Metro, Michigan Processing and Distribution Center will consolidate several originating and destinating operations, while providing related mail processing administrative and building maintenance support. It allows the termination of several annex facility leases no longer required as a result of the consolidation; and

- The Oklahoma City, Oklahoma Processing and Distribution Center and Vehicle Maintenance Facility will alleviate space deficiencies and enable the consolidation of split operations, thereby increasing operating windows, reducing transportation and labor costs, and increasing service and productivity.

FY 2007 CAPITAL COMMITMENTS

The FY 2007 capital commitment plan will continue to focus on funding projects that provide high returns on investment and address automation and infrastructure requirements. The plan of $3.5 billion reflects the priorities outlined in the Strategic Transformation Plan.

The major capital plan categories are summarized in this table.

FY 2007 Capital Commitments

	FY 2006 Estimate	FY 2007 Plan
Mail Processing Equipment	$ 786	$ 1,552
Facilities	915	1,288
Infrastructure and Support	149	413
Retail	–	65
Vehicles	15	230
Total	$1,865	$ 3,548
($ Millions)		

Mail Processing Equipment

The FY 2007 capital plan for equipment is $1.6 billion or 44 percent of the total capital plan. The majority of this is for programs that raise productivity and reduce operating costs.

Phase-One of the Flat Sequencing System (FSS) program will deploy 100 systems to multiple facilities. The FSS will fully automate the Delivery Point Sequencing of flat mail for selected delivery sites, reducing carrier in-office sorting of flat mail. This system sorts flat mail in carrier delivery point sequence at a rate of 40,000 pieces per hour and has two-pass operational throughput nearing 18,000 pieces per run hour. The tray handling systems automatically deliver first, second and final sweep mail to system feeders and dispatch points. The FSS includes automatic induction, mail prep stations, buffer/transport, and auto-feed on first pass.

The Advanced Facer Canceller System (AFCS) 2000 program upgrades the aging AFCS by eliminating end of life issues on parts, reducing maintenance hours, and providing operational improvements. The program replaces the aging scanning and controls technology, while also improving mail tracking and reducing mechanical jams. Existing scanners and indicia detectors get replaced and a switchback module is added to correctly face all lead and trail mail in one direction.

The third phase of the Automated Package Processing Systems (APPS) continues to automate small parcel and bundle sorting and improve productivity. The APPS provides greater processing capacity through automatic package singulation and address reading through an Optical Character Reader/Bar Code Reader/Video Coding System.

Facilities

In FY 2007, the planned commitment for facilities is $1.3 billion, or 36 percent of the total capital plan. This portion of the plan reflects continued efforts to increase investments in facility infrastructure, replacements, and major mail processing facilities. With an expected growth of 1.9 million delivery points in FY 2007, the facility infrastructure will be maintained through priority replacement projects, energy efficiency improvements, as well as repair and alteration projects to maintain the useful life and efficiency of current facilities. Additionally, funding in this category will support network and flat sequencing projects.

Infrastructure and Support

The Infrastructure and Support category is planned at $413 million. Investments in this category include information/communication network and system requirements, support funds for automation programs, and maintenance equipment. A major component of this category in FY 07 is the Chiller Replacement Program for cooling systems. Although defined as compliance with EPA's mandatory phase out of certain refrigerants, these new chillers are more energy efficient and will produce significant savings. Funding will also be committed to energy efficient lighting projects.

This category also includes support funds for major automation programs, as well as funds for maintenance equipment such as forklifts, scrubbers, scissors lifts, and office equipment.

Retail

In FY 2007, $65 million will be committed to retail projects as the Postal Service continues to improve self service and point of sale technology. These projects are designed to provide customers with convenient access to postal products and services up to 24 hours a day 7 days a week in more locations.

Vehicles

In FY 2007, the planned commitment for vehicles totals $230 million and is mainly for the purchase of fuel efficient carrier vehicles. This initiative will improve service by providing timely and reliable end-to-end service through efficient delivery operations. It will allow the rural carriers to have more right-hand drive delivery vehicles. It will also replace aged vehicles that have reached the end of their useful lives. Additional commitments include funding for auxiliary vehicle equipment such as tow-hitches, lift gates, and snow removal equipment.

FY 2007 Capital Spending Plan

The FY 2007 plan provides for approximately $2.2 billion in cash outlays. Approximately $1.5 billion relate to commitments made in prior years. The remaining $700 million is for proposed FY 2007 commitments. Capital spending for FY 2006 and 2007 approximate depreciation expense levels.

FY 2007 Capital Spending Plan

	FY 2006 Estimate	FY 2007 Plan
Mail Processing Equipment	$987	$913
Facilities	789	792
Infrastructure and Support	448	390
Retail	35	36
Vehicles	102	104
Total	$2,361	$ 2,235
($ Millions)		

FINANCING PLAN

FY 2006 Financing Activity

Current FY 2006 estimates are for $1.2 billion in net income and $3.9 billion in cash flow from operations. Capital cash outlays are expected to total a close-to-plan $2.4 billion, leaving free cash flow of $1.5 billion. Borrowing of $1.9 billion is now projected for year-end. The year-end borrowing will be the first debt transaction of FY 2006, following zero debt on a daily basis through the year.

FY 2007 Financing Activity

The FY 2007 Operating Plan projects cash flow from operations of $4.0 billion. Capital cash outlays are estimated to be $2.2 billion. The FY 2007 plan includes free cash flow from operations of $1.8 billion, and a projected increase in year-end debt of $1.2 billion. Debt outstanding on the last day of fiscal years 2006 and 2007 is projected to be $1.9 billion and $3.1 billion, respectively. Cash flow from operations will be applied to minimize debt during the course of the year.

FY 2007 Financing Plan

	FY 2006 Estimate	FY 2007 Plan
Beginning Year:		
Cash	$ 0.9	$ 1.3
Escrow Balance	–	3.0
Cash Flow From Operations	$ 3.9	$ 4.0
+ Capital Cash Outlays	(2.4)	(2.2)
= Free Cash Flow	$ 1.5	$ 1.8
+ Cash From Financing	1.9	1.2
= Change in Cash Before Escrow	$ 3.4	$ 3.0
End of Year Cash	$ 1.3	$ 1.0
Restricted Cash – Escrow	$ 3.0	$ 6.3
Average FY Debt Outstanding	–	$ 0.2
Debt Outstanding at Year End	$ 1.9	$ 3.1
($ Billions)		