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Operations

1999 Compared to 1998

The following tables set forth information showing the change in revenue, average daily package volume, and average revenue per piece, both in dollars or amounts and in percentage terms:

	Year Ended December 31,		Change	
	1999	1998	$	%
Revenue (in millions):				
U.S. domestic package:				
Next Day Air	**$ 5,240**	$ 4,690	$ 550	11.7%
Deferred	**2,694**	2,464	230	9.3
Ground	**14,379**	13,496	883	6.5
	22,313	20,650	1,663	8.1
International package:				
Domestic	**924**	953	(29)	(3.0)
Export	**2,479**	2,176	303	13.9
Cargo	**327**	270	57	21.1
	3,730	3,399	331	9.7
Non-package	**1,009**	739	270	36.5
Consolidated	**$27,052**	$24,788	$ 2,264	9.1%
Average Daily Package Volume (in thousands):			#	
U.S. domestic package:				
Next Day Air	**1,039**	938	101	10.8%
Deferred	**852**	783	69	8.8
Ground	**10,016**	9,645	371	3.8
	11,907	11,366	541	4.8
International package:				
Domestic	**711**	730	(19)	(2.6)
Export	**303**	256	47	18.4
	1,014	986	28	2.8
Consolidated	**12,921**	12,352	569	4.6%
Average Revenue Per Piece:			$	
U.S. domestic package:				
Next Day Air	**$ 19.86**	$ 19.69	$ 0.17	0.9%
Deferred	**12.45**	12.39	0.06	0.5
Ground	**5.65**	5.51	0.14	2.5
Total	**7.38**	7.15	0.23	3.2
International package:				
Domestic	**5.12**	5.14	(0.02)	(0.4)
Export	**32.21**	33.46	(1.25)	(3.7)
Total	**13.21**	12.49	0.72	5.8
Consolidated	**$ 7.84**	$ 7.58	$ 0.26	3.4%

U.S. domestic package revenue increased more than $1.6 billion primarily due to a 4.8% increase in average daily package volume combined with a 3.2% improvement in revenue per piece. Package volume growth was experienced in all products, with average volumes for our Next Day Air and Deferred products growing at 10.8% and 8.8%, respectively. We generated substantial growth in our Ground revenue, which comprises 64% of our U.S. domestic package revenue, based on average volume growth of 3.8% and a 2.5% improvement in average revenue per piece.

During the first quarter of 1999, we increased rates for standard ground shipments an average of 2.5% for commercial deliveries. The ground residential charge continued to be $1.00 over the commercial ground rate, with an additional delivery area surcharge added to certain less accessible areas. In addition, we increased rates for UPS Next Day Air, UPS Next Day Air Saver, and UPS 2nd Day Air an average of 2.5%, while we decreased the rate for UPS 2nd Day Air A.M. by 2.2%. The rate for UPS Next Day Air Early A.M. did not change. Rates for international shipments originating in the United States did not increase for UPS Worldwide Express, Worldwide Express Plus, UPS Worldwide Expedited, and UPS International Standard service. Rate changes for shipments originating outside the U.S. were made throughout the past year and varied by geographic market.

The increase in international package revenue was primarily due to an overall improvement in product mix, specifically volume growth for our export products. All international operations posted double-digit volume growth in export services, with the largest increases experienced in our Asia Pacific and European operations. Due to the strong growth of our international export products, our total average revenue per piece for the international segment increased $0.72, or 5.8%.

We have added a "Cargo" line item within the international package revenue category. Previously, this revenue was included in the international export and the non-package revenue amounts. Amounts for all periods presented have been restated to reflect this change.

The growth in non-package revenue resulted primarily from the continued growth of the UPS Logistics Group. This growth reflects both new business and increased business with existing customers. Revenue for the non-package segment was also increased by the new arrangement for providing excess value package insurance for our customers.

Operating expenses increased by $1.366 billion, or 6.3%, which was less than our increase in revenue of 9.1%. Compensation and benefit expenses accounted for $939 million of this increase. Purchased transportation costs increased by $160 million and fuel costs increased by $77 million. The operating margin, defined as operating profit as a percentage of revenue, for 1999 was 14.7 compared to 12.5 in 1998. This improvement was largely due to containment of operating expense growth through better utilization of existing capacity and from continued company-wide cost containment efforts.

The following table shows the change in operating profit, both in dollars and in percentage terms:

	Year Ended December 31,		Change	
(in millions)	**1999**	1998	$	%
Operating Segment				
U.S. domestic package	**$ 3,568**	$ 2,899	$ 669	23.1%
International package	**252**	56	196	350.0
Non-package	**168**	135	33	24.4
Consolidated operating profit	**$ 3,988**	$ 3,090	$ 898	29.1%

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U.S. domestic package operating profit improved due to the volume and revenue improvements discussed previously, combined with the containment of operating expense growth.

Our international package operating profit improved significantly in 1999 due to a shift to higher yielding export packages. Average daily volume for our export products grew 18.4% over 1998. The Europe and Asia Pacific regions contributed significantly to overall operating profit improvements.

The increase in non-package operating profit is largely due to the new arrangement for providing excess value package insurance for our customers. The new arrangement for excess value package insurance, which was implemented in the fourth quarter of 1999, increased non-package operating profit by $60 million. This increase was offset somewhat by continued start-up costs at UPS Capital Corporation, higher third-party underwriting losses for UPINSCO, our captive insurance company, and a reduction in intersegment profit. The UPS Logistics Group experienced a small decrease in operating profit compared to last year. This decrease was due to third-party transportation costs for the group's SonicAir subsidiary and higher fuel costs for its UPS Truck Leasing subsidiary. These decreases were offset somewhat by higher operating profits for the group's Worldwide Logistics subsidiary.

In 1999 quarterly financial statements, we did not allocate capitalized software to individual segments and reported the amounts capitalized as a separate "Corporate" line item. However, for the year ended December 31, 1999, all capitalized software costs, including amounts capitalized in prior quarters, have been allocated to the individual segments which benefit from the software.

The increase in investment income of $93 million for the year is due to large cash, cash equivalents, marketable securities and short-term investments balances we have maintained during 1999, including the IPO proceeds received in November.

Net income for 1999 decreased by $858 million from 1998, resulting in a decrease in diluted earnings per share from $1.57 in 1998 to $0.77 in 1999. These results reflect the charge we recorded during the second quarter of 1999, resulting from an unfavorable ruling of the U.S. Tax Court. Excluding the impact of this one-time charge of $1.442 billion, our net income for 1999 would have been $2.325 billion, with an associated diluted earnings per share of $2.04. Further discussion of this matter is included in the Liquidity and Capital Resources section.

1998 Compared to 1997

The following tables set forth information showing the change in revenue, average daily package volume, and average revenue per piece, both in dollars or amounts and in percentage terms:

	Years Ended December 31, 1998	Years Ended December 31, 1997	Change $	Change %
Revenue (in millions):				
U.S. domestic package:				
Next Day Air	$ 4,690	$ 4,054	$ 636	15.7%
Deferred	2,464	2,314	150	6.5
Ground	13,496	12,500	996	8.0
	20,650	18,868	1,782	9.4
International package:				
Domestic	953	919	34	3.7
Export	2,176	1,922	254	13.2
Cargo	270	226	44	19.5
	3,399	3,067	332	10.8
Non-package	739	523	216	41.3
Consolidated	$24,788	$22,458	$ 2,330	10.4%
Average Daily Package Volume (in thousands):			#	
U.S. domestic package:				
Next Day Air	938	822	116	14.1%
Deferred	783	771	12	1.6
Ground	9,645	9,521	124	1.3
	11,366	11,114	252	2.3
International package:				
Domestic	730	678	52	7.7
Export	256	217	39	18.0
	986	895	91	10.2
Consolidated	12,352	12,009	343	2.9%
Average Revenue Per Piece:			$	
U.S. domestic package:				
Next Day Air	$ 19.69	$ 19.49	$ 0.20	1.0%
Deferred	12.39	11.86	0.53	4.5
Ground	5.51	5.19	0.32	6.2
Total	7.15	6.71	0.44	6.6
International package:				
Domestic	5.14	5.36	(0.22)	(4.1)
Export	33.46	35.01	(1.55)	(4.4)
Total	12.49	12.55	(0.06)	(0.5)
Consolidated	$ 7.58	$ 7.15	$ 0.43	6.0%

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The increase in U.S. domestic package revenue in 1998 resulted from continued improvement in product mix, combined with generally higher revenue per piece. The 1997 revenues were adversely affected by the 15-day Teamsters strike. The Teamsters union, which, at the time, represented about 203,000 of our employees, was on strike from August 4 through August 19, 1997. In addition, the Independent Pilots Association, which represents all of our non-management pilots, observed picket lines in support of the Teamsters strike. Excluding the period of the strike, average daily domestic volume in 1998 was 2.2% below 1997, reflecting residual lost volume following the strike. Domestic express volume, however, increased by 4.0%.

During the first quarter of 1998, we increased rates for standard ground shipments an average of 3.6% for commercial deliveries and increased the ground residential premium from $.80 to $1.00 over the commercial ground rate. In addition, we increased rates for each of UPS Next Day Air, UPS 2nd Day Air, and UPS 3 Day Select about 3.3%. Rates for international shipments originating in the U.S. did not change for UPS Worldwide Express, UPS Worldwide Expedited, and UPS Standard Service to Canada. Rate changes for shipments originating outside the U.S. were made throughout 1998 and varied by geographic market.

The increase in international package revenue in 1998 was attributable primarily to a 10.2% increase in volume and an improvement in product mix. The revenue increase was partially offset by the stronger U.S. dollar. Europe was a significant contributor to international revenue growth in 1998 as a result of a 12.2% volume increase and improved product mix. The increase in non-package revenue in 1998 was driven mainly by continued growth of the UPS Logistics Group.

Consolidated operating expenses increased $938 million, or 4.5%, in 1998 over 1997, while the operating margin improved from 7.6 during 1997 to 12.5 during 1998. Compensation and benefits expenses increased $1.057 billion in 1998, in part due to labor costs not incurred during the Teamsters strike in August 1997. Other operating expenses decreased $119 million from 1997 to 1998, mainly driven by lower fuel costs and the reduction of overhead costs in 1998.

The following table shows the change in operating profit, both in dollars and in percentage terms:

(in millions)	Years Ended December 31, 1998	1997	Change $	%
Operating Segment				
U.S. domestic package	$ 2,899	$ 1,654	$ 1,245	75.3%
International package	56	(67)	123	*
Non-package	135	111	24	21.6
Consolidated operating profit	$ 3,090	$ 1,698	$ 1,392	82.0%

** Not meaningful*

Approximately $703 million of the U.S. domestic package operating profit increase resulted from improvements in U.S. domestic revenue per piece, improved product mix and containment of operating expense growth. The remaining $542 million of the increase reflects the change between August 1998 and August 1997, the period in which the Teamsters strike occurred.

The favorable trend in international operations resulted primarily from higher volume, improved product mix, and better utilization of existing capacity. Most of this improvement was due to the Europe region. Despite the economic problems in Asia, operating results associated with the Asia Pacific region continued to improve in 1998.

Net income increased by $832 million in 1998 over 1997. Approximately $496 million of this improvement was due primarily to higher revenue per piece on U.S. domestic products, improved product mix, improved international operating results, and the containment of operating expense growth. The remaining increase of $336 million resulted from the change in net income for August 1998 as compared to August 1997, the period in which the Teamsters strike occurred.

Liquidity and Capital Resources

Our primary source of liquidity is our cash flow from operations. We maintain significant cash, cash equivalents, marketable securities and short-term investments, amounting to $6.278 billion at December 31, 1999. Of this amount, $5.266 billion represents the net proceeds from our initial public offering, which was completed in November 1999. We used the majority of the IPO proceeds to fund a cash tender offer to purchase Class A-1 shares from shareowners. The tender offer, which was announced on February 4, 2000, and expired on March 3, 2000, was for up to 100,893,277 shares at a price of $60 per share. The actual number of shares validly tendered and accepted for purchase by us was 68,312,335, which will result in a cash expenditure of approximately $4.099 billion and reduce our outstanding Class A shares accordingly. The remaining IPO proceeds will be available for general corporate purposes, which may include future additional purchases of UPS shares.

We maintain a commercial paper program under which we are authorized to borrow up to $2.0 billion. Approximately $102 million was outstanding as of December 31, 1999. The average interest rate on the amount outstanding at December 31, 1999 was 5.8%.

We maintain two credit agreements with a consortium of banks. These agreements provide revolving credit facilities of $1.25 billion each, with one expiring in April 2000 and the other expiring in April 2003. Interest on any amounts we borrow under these facilities would be charged at 90-day LIBOR plus 15 basis points. There were no borrowings under either of these agreements as of December 31, 1999.

We also maintain a European medium-term note program with a borrowing capacity of $1.0 billion. Under this program, we may issue notes from time to time denominated in a variety of currencies. At December 31, 1999, $500 million was available under this program. Of the amount outstanding at December 31, 1999, $200 million bears interest at a stated interest rate of 6.625% and $300 million bears interest at a stated interest rate of 6.25%.

In January 1999, we filed a shelf registration statement with the SEC, under which we may issue debt in the U.S. marketplace of up to $2.0 billion. The debt may be denominated in a variety of currencies. There is approximately $55 million issued under this shelf registration statement at December 31, 1999.

On August 9, 1999, the U.S. Tax Court issued an opinion unfavorable to UPS regarding a Notice of Deficiency asserting that we are liable for additional tax for the 1983 and 1984 tax years. The Court held that we are liable for tax on income of Overseas Partners Ltd. ("OPL"), a Bermuda company, which had reinsured excess value package insurance purchased by our customers beginning in 1984. The Court held that for the 1984 tax year we are liable for taxes of $31 million on income reported by OPL, penalties and penalty interest of $93 million and interest for a total after-tax exposure estimated at approximately $246 million. In February 2000, the U.S. Tax Court entered a decision in accord with its opinion.

In addition, during the first quarter of 1999, the IRS issued two Notices of Deficiency asserting that we are liable for additional tax for the 1985 through 1987 tax years, and the 1988 through 1990 tax years. The primary assertions by the IRS relate to the reinsurance of excess value package insurance, the issue raised for the 1984 tax year. The IRS has based its assertions on the same theories included in the 1983–1984 Notice of Deficiency.

We anticipate that the IRS will take similar positions for tax years subsequent to 1990. Based on the Tax Court opinion, we currently estimate that our total after-tax exposure for the tax years 1984 through 1999 could be as high as $2.353 billion. We are in the process of analyzing our position in light of the Tax Court opinion and are evaluating our options, including appeal of the Tax Court decision, continuance of the litigation, or negotiation of a settlement. In the second quarter 1999 financial statements, we recorded a tax assessment charge of $1.786 billion, which included an amount for related state tax liabilities. The charge included taxes of $915 million and interest of $871 million. This assessment resulted in a tax benefit of $344 million related to the interest component of the assessment. As a result, our net charge to net income for the tax assessment was $1.442 billion, increasing our total after-tax reserve at that time with respect to these matters to $1.672 billion. The tax benefit of deductible interest is included in income taxes; however, since none of the income on which this tax assessment is based is our income, we have not classified the tax charge as income taxes.

We determined the size of our reserve with respect to these matters in accordance with generally accepted accounting principles based on our estimate of our most likely liability. In making this determination, we concluded that it was more likely that we would be required to pay taxes on income reported by OPL and interest, but that it was not probable that we would be required to pay any penalties and penalty interest. If penalties and penalty interest ultimately are determined to be payable, we would have to record an additional charge of up to $681 million.

On August 31, 1999, we deposited $1.349 billion with the IRS related to these matters for the 1984 through 1994 tax years. We included the profit of the excess value package insurance program, using the IRS's methodology for calculating these amounts, for both 1998 and 1999 in filings we made with the IRS in the fourth quarter of 1999. In February 2000, we deposited $339 million with the IRS related to these matters for the 1995 through 1997 tax years. The above described deposits and filings were made in order to stop the accrual of interest, where applicable, on that amount of the IRS's claim, without conceding the IRS's position or giving up our right to appeal the Tax Court's decision.

Effective October 1, 1999, we implemented a new arrangement for providing excess value package insurance for our customers through UPS subsidiaries. This new arrangement results in including in our non-package operating segment the operations of the excess value package insurance program offered to our customers. This revised arrangement should eliminate the issues considered by the Tax Court in the Notices of Deficiency relating to OPL for periods after September 1999.

We recently have been named as a defendant in nine lawsuits which seek to hold us (and in two cases, other defendants) liable for the collection of premiums for excess value coverage ("EVC") in connection with package shipments since 1984. These cases generally claim that we acted as an insurer without complying with state insurance laws and regulations, and that the price for EVC was excessive. All of these cases are currently pending in federal courts, and we have requested that the cases be consolidated for pre-trial purposes in a multi-district litigation proceeding before a single federal court. Each of these cases is in its initial stages, no discovery has commenced, and no class has been certified. These actions all developed after the August 9, 1999, Tax Court opinion was rendered. We believe the allegations have no merit and intend to defend them vigorously. The ultimate resolution of these matters cannot presently be determined.

As part of our 1997-2002 collective bargaining agreement with the Teamsters, we agreed that we would create 2,000 new full-time jobs from existing part-time jobs during each year of the contract. There was a provision, however, which nullified this obligation if there was a reduction in volume that resulted in layoffs. At the end of the first contract year (July 31, 1998), our shipping volume was still below pre-strike levels and employees were laid off. Therefore, we believed that we were not obligated to create the 2,000 jobs for the first year of the contract. The Teamsters filed a grievance concerning this issue, and the case was submitted to an arbitrator. In February 2000, the arbitrator ruled against us and ordered us to create the 2,000 new full-time jobs from existing part-time positions within 90 days of the arbitrator's decision, and to make whole the employees selected for the full-time positions for any lost wages or benefits. We are in the process of creating these full-time jobs, identifying the employees that will fill the new jobs and quantifying the financial impact of this matter. Our package volume surpassed pre-strike levels in 1999, and thus we are in the process of creating the 2,000 full-time jobs called for in the third year of the contract. We are in the process of negotiating with the Teamsters over our obligation to create the 2,000 full-time jobs for the second year of the contract. We do not believe that the eventual amount will be material to our financial condition or liquidity.

On November 22, 1999, the U.S. Occupational Safety and Health Administration ("OSHA") proposed regulations to mandate an ergonomics standard that would require American industry to make significant changes in the workplace in order to reduce the incidence of musculoskeletal complaints such as low back pain. If adopted as proposed and substantially enforced, these regulations would require us to make extensive changes in the physical layout of our distribution centers and to hire significant numbers of additional full-time and part-time employees. Should this occur, we believe that the cost of compliance could be material to our financial condition, results of operations and liquidity. Our competitors, as well as the remainder of American industry, would incur similar costs. We have filed comments with OSHA, challenging the medical support and economic and technical feasibility of the proposed regulations.

We believe that funds from operations and borrowing programs will provide adequate sources of liquidity and capital resources to meet our expected long-term needs for the operation of our business, including anticipated capital expenditures such as commitments for aircraft purchases through 2004.

Following is a summary of capital expenditures:

(in millions)	Years Ended December 31, 1999	1998	1997
Buildings and facilities	$ 579	$ 408	$ 523
Aircraft and parts	433	942	907
Vehicles	139	141	333
Information technology	325	154	221
	$ 1,476	$ 1,645	$ 1,984

Our capital expenditures have declined over the past three years primarily as a result of better utilization of our existing transportation system and other assets and our focus on return on invested capital.

We anticipate capital expenditures of approximately $2.1 billion in 2000 and $2.6 billion in 2001. These expenditures will provide for replacement of existing capacity and anticipated future growth and include the projected cost of capitalized software.

Market Risk

We are exposed to a number of market risks in the ordinary course of business. These risks, which include interest rate risk, foreign currency exchange risk, and commodity price risk, arise in the normal course of business rather than from trading. We have examined our exposures to these risks and concluded that none of our exposures in these areas is material to fair values, cash flows, or earnings. We have engaged in several strategies to manage these market risks.

Our indebtedness under our various financing arrangements creates interest rate risk. In connection with each debt issuance and as a result of continual monitoring of interest rates, we may enter into interest rate swap agreements for purposes of managing our borrowing costs.

For all foreign currency-denominated borrowing and certain lease transactions, we simultaneously entered into currency exchange agreements to lock in the price of the currency needed to pay the obligations and to hedge the foreign currency exchange risk associated with such transactions. We are exposed to other foreign currency exchange risks in the ordinary course of our business operations due to the fact that we provide our services in more than 200 countries and territories, and collection of revenues and payment of certain expenses may give rise to currency exposure.

We require significant quantities of gasoline, diesel fuel, and jet fuel for our aircraft and delivery vehicles. We therefore are exposed to commodity price risk associated with variations in the market price for energy products. We manage this risk with a hedging strategy designed to minimize the impact of sudden, catastrophic increases in the prices of energy products while allowing us to benefit if fuel prices decline. Our hedging program is designed to moderate the impact of fluctuating crude oil prices and maintain our competitive position relative to our industry peers.

Future Accounting Changes

In June 1998, the FASB issued Statement No. 133, “Accounting for Derivative Instruments and Hedging Activities” (“FAS 133”), as amended by Statement No. 137, which provides a comprehensive and consistent standard for the recognition and measurement of derivatives and hedging activities. The new statement is effective for fiscal years beginning after June 15, 2000, with earlier adoption encouraged but not required. We have not yet completed our analysis of the effects of adopting this standard.

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Impact of the Year 2000 Issue

Introduction

The term "year 2000 issue" is a general term used to describe the various problems that may result from the improper processing of dates and date-sensitive calculations by computers and other machinery as the year 2000 was approached and reached. Our failure to appropriately address a material year 2000 issue, or the failure by any third parties who provide goods or services that are critical to our business activities to appropriately address their year 2000 issues, could have a material adverse effect on our financial condition, liquidity, or results of operations.

State of Readiness

Since entering the year 2000, we have not experienced any significant disruptions related to the year 2000 issue, nor are we aware of any significant year 2000-related disruptions impacting our customers and suppliers. While we will continue to monitor our business-critical information technology assets, we do not anticipate that we will experience any significant year 2000-related disruptions to our internal systems, nor on those of our customers and suppliers.

Costs to Address the Year 2000 Issue

Costs incurred to achieve year 2000 readiness were charged to expense as incurred. Such costs include both internal resources dedicated to achieving year 2000 compliance, as well as the costs of independent consultants retained to assess our year 2000 initiative. The costs related to our year 2000 initiative will total approximately $104 million, substantially all of which were incurred prior to December 31, 1999.

Contingency Plans

In the normal course of business, we maintain and deploy contingency plans designed to address potential business interruptions. We completed risk assessment reviews under our year 2000 initiative for each business unit and developed further contingency plans specifically related to the year 2000 issue. These contingency plans remain in place in the case of a year 2000-related disruption to our internal systems or to the systems of our customers and suppliers.

Forward-Looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations and Liquidity and Capital Resources, and other parts of this Report, contain "forward-looking" statements about matters that are inherently difficult to predict. Those statements include statements regarding our intent, belief, or current expectations. Some of the important factors that affect these statements have been described above as each subject is discussed. Such forward-looking statements involve risks and uncertainties that may affect future developments such as, for example, our continued ability to successfully compete, especially with foreign competition, the reliability and availability of rail transportation, the growth rate of e-commerce in relation to our expectations, adverse weather conditions, and changing fuel prices. Additional information concerning these risks and uncertainties and other factors you may wish to consider are provided in the "Risk Factors" section of our Prospectus dated November 9, 1999, as filed with the Securities and Exchange Commission.