



September 9, 2005

JOHN E. POTTER  
POSTMASTER GENERAL, CHIEF EXECUTIVE OFFICER

SUBJECT: Audit Report – Air Transportation Networks – International Mail – Extra Territorial Offices of Exchange (Report Number NL-AR-05-010)

This report presents results from our audit of Extra Territorial Offices of Exchange (ETOEes) (Project Number 04YG023NL001).

ETOEes are commercial businesses affiliated with foreign postal administrations. They compete in the international shipping and delivery market with the Postal Service and commercial shippers not affiliated with foreign posts. ETOEes focus their business on high dollar bulk shipments from large customers in major cities. Unlike the Postal Service, ETOEes are not required to:

- Provide universal service to remote or less profitable geographical regions.
- Use U.S. domestic airlines at rates set by the U.S. Department of Transportation.

Unlike commercial shippers not affiliated with foreign posts, ETOEes have access to the universal delivery networks of national postal administrations at rates intended for national posts.

ETOEes operate in the United States as permitted by international agreements intended to foster cooperation in the international mail market. They are also supported by U.S. public policy dating back to the Reagan Administration. Postal Service officials believe that because ETOEes do not bear universal service costs, are not restricted to using U.S. domestic airlines, can negotiate favorable transportation contracts with all international air carriers, and have access to postal rates intended for official national postal administrations, they have an unfair competitive advantage over both the Postal Service and commercial shippers not affiliated with foreign posts. Officials also believe ETOEes engage in improper and unauthorized practices, adversely impact legitimate competition, and create a security risk.

In April 2005, the Postmaster General asked the Office of Inspector General (OIG) to examine ETOE operations. The objective of our audit was to determine if practices or procedures used by ETOEes were unfair, improper, or unauthorized. Our audit

concluded that ETOEs take competitive advantage of avenues unavailable to national postal administrations, and also take competitive advantage of avenues unavailable to commercial shippers not affiliated with national posts. In addition, our audit concluded that some ETOE practices are improper or unauthorized, create vulnerability to terrorist attack, and create certain unfair financial burdens on the Postal Service.

To help resolve these issues, the Postal Service would need to work with Congress; the Departments of State, Justice, Commerce, and Homeland Security; the Universal Postal Union; and other national postal administrations, to establish law, regulation, and procedure which:

Reduces the threat of terrorist attack

- Eliminates the unfair advantages ETOEs have over the Postal Service, including anticompetitive restrictions which compel the Postal Service to transport international mail on U.S. domestic airlines at rates set by the Department of Transportation.
- Eliminates the unfair advantages ETOEs have over international shipping and delivery businesses not affiliated with foreign posts, including the elimination of ETOE use of Universal Postal Union documentation and indicia.

We appreciate the cooperation and courtesies provided by your staff during the audit. If you have any questions or need additional information, please contact Mary Demory, Deputy Assistant Inspector General for Core Operations, or me at (703) 248-2300.

/s/ Gordon C. Milbourn III

Gordon C. Milbourn III  
Assistant Inspector General  
for Audit

Attachment

cc: Patrick R. Donahoe  
William P. Galligan  
Paul E. Vogel  
Anthony M. Pajunas  
Steven R. Phelps

## INTRODUCTION

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### Background

Extra Territorial Offices of Exchange (ETOE) are commercial businesses affiliated with foreign postal administrations like Swiss Post, Deutsche Post (Germany), or Royal Mail (Great Britain). These foreign post affiliates compete in the international shipping and delivery market with the U.S. Postal Service and commercial shippers not affiliated with foreign posts. Competitors in this market vie for the bulk shipment of business or government correspondence, magazines, advertising, airline frequent flyer statements, various publications, packages shipped by catalog or on-line retail companies, and other products.

Global Mail is an ETOE  
affiliated with  
Deutsche Post.

World-wide, there are  
120 ETOEs officially  
registered with the  
Universal Postal Union.  
Twenty-two ETOEs  
operate within the United  
States.

Photograph taken near  
Miami International Airport  
May 25, 2005.



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### Public Policy

The Universal Postal Union (UPU) is an international agency of the United Nations established to encourage international postal collaboration and improve postal services worldwide. The United States is one of 190 UPU member nations, and is represented at the UPU by the State Department. ETOEs operate in the United States as permitted by UPU agreements intended to foster cooperation in the international mail market.

ETOE are also supported by U.S. public policy dating back to the Reagan Administration. On May 1, 1986, President Reagan wrote to Postmaster General Albert Casey, explained that he wanted to encourage free enterprise, and asked that the Postmaster General work with the Secretary of State, the Attorney General, and foreign nations to permit

and promote marketplace competition in international mail. Subsequent to President Reagan's request, the Postal Service suspended various legal restraints, and created an environment where ETOEs could operate in the United States.

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Universal Postal Union  
Rates and Arbitrage

The UPU establishes the rates member nations pay each other for mail originating in one country and terminating in another. When the same product is priced differently in two or more markets, it is possible to exploit the imbalance. The practice of exploiting such imbalance is known as arbitrage.

Depending on the characteristics of mail—letters, packages, books, or other items—UPU rates received from a foreign post can be more or less than revenues received on similar mail accepted domestically. In addition, when setting rates, the UPU discriminates between developing countries and industrialized countries. In fact, there is wide discrepancy between domestic rates, developing country rates, and industrialized country rates. As a result, there are innumerable permutations of arbitrage opportunities. ETOEs exploit these opportunities in ways not available to official national postal administrations, or to commercial shippers not affiliated with official posts.

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Universal Service

The postal administrations of the 190 UPU member nations are generally obligated to provide mail service universally within their borders—and to bear the cost of that universal service obligation. ETOEs, as commercial businesses, do not have a universal service obligation. Instead, ETOEs focus on high profit business from bulk shippers in major cities. However, as the affiliates of foreign posts, ETOEs have access to the universal delivery networks of official UPU postal administrations at rates established for those postal administrations.

The Postal Service believes that because ETOEs do not bear universal service costs, but have access to UPU rates, they have an unfair advantage over both the Postal Service and nonaffiliated commercial shippers. Consequently, the Postal Service believes ETOEs should be restricted. To that end, in September 2001, the Postal Service changed its policy to refuse ETOE shipments inbound to the United States, unless the ETOE paid U.S. domestic mail rates.

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The Position of ETOE  
Proponents

Some ETOE proponents<sup>1</sup> argue that ETOEs should not be restricted because restrictions stifle competition in the international shipping and delivery market—and in addition, may have significant economic and legal implications. For example, ETOE proponents explain:

- ETOEs are a positive catalyst for change, and restricting ETOEs ignores the trend toward international business globalization and the realities of the global business mailer.
- ETOEs are not the problem, but are only a symptom of a discriminatory UPU rate system, and that rather than focusing on restrictions, the UPU should focus on reforming discriminatory UPU rates.
- ETOE restrictions may be subject to international legal challenges under the World Trade Organization negotiated General Agreement on Trade in Services.

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The Postal Service  
Position

Postal Service officials counter that ETOEs are not a positive catalyst for change—and do not foster competition. They explain ETOEs engage in unfair, improper and unauthorized practices; adversely impact legitimate competition; and create a security risk.

In the fall of 2004, the Postal Inspection Service found U.S. based ETOEs were improperly using Postal Service equipment to dispatch international shipments. As a result, in February 2005, the Postal Service notified foreign posts, ETOEs, airlines, and others, that:

- Unauthorized use of Postal Service equipment violated federal law.
- Unauthorized use of Postal Service equipment had significant financial and security implications.
- The Postal Service would seize any of its equipment improperly used to transport ETOE dispatches at U.S. airports.

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<sup>1</sup>Leong, Joy M., Daniel Bahar, and Dimosthenis Papakrivopoulos. 2005. "ETOE: Arbitrageurs or Vehicles of Change in Postal Liberalization?" In Regulatory and Economic Challenges in the Postal and Delivery Sector, edited by M.A. Crew and P.R. Kleindorfer, Boston, MA: Kluwer Academic Publishers.

In April 2005, the Postmaster General asked the Office of Inspector General (OIG) to examine ETOE operations.

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**Objectives, Scope,  
and Methodology**

The objective of our audit was to determine if practices or procedures used by ETOEs were unfair, improper, or unauthorized.

During our work we interviewed Postal Service officials at headquarters and in various Postal Service areas and districts. We analyzed various articles and literature about ETOEs and the global postal environment, interviewed authors, and considered divergent views. We also consulted with economists, lawyers, computer analysts, other subject matter experts, and relied upon their expertise.

**Cathay Pacific is an international flag airline based in Hong Kong. ETOEs can use Cathay Pacific for international shipments to Asia and Europe.**

**Photograph taken at O'Hare International Airport Chicago, Illinois, May 16, 2005.**



We visited international airports in New York, Newark, Chicago, Miami, Los Angeles, and San Francisco. We interviewed personnel at international mail service centers, international air mail record units, business mail entry units, and mail processing plants. We interviewed U.S. Customs agents, postal inspectors, and Postal Service transportation managers. We observed and photographed international mail receiving operations, airport ramp operations, air cargo operations, and business mail entry unit operations. We inspected inbound international mail and accompanying documentation, and we analyzed data on inbound ETOE shipment volume.

In addition, we participated on a joint task force with the Postal Inspection Service, the U.S. Department of

Commerce, the U.S. Customs and Border Protection, and the U.S. Postal Service. The objective of the task force was to interdict improper use of Postal Service equipment. During task force operations we visited ETOEs, interviewed ETOE managers and employees, observed and photographed operations, and identified Postal Service equipment in ETOE possession.

We conducted work associated with this report from April through September 2005 in accordance with generally accepted government auditing standards, and we included such tests of internal controls as we considered necessary under the circumstances. We discussed our observations and conclusions with management officials and included their comments where appropriate.

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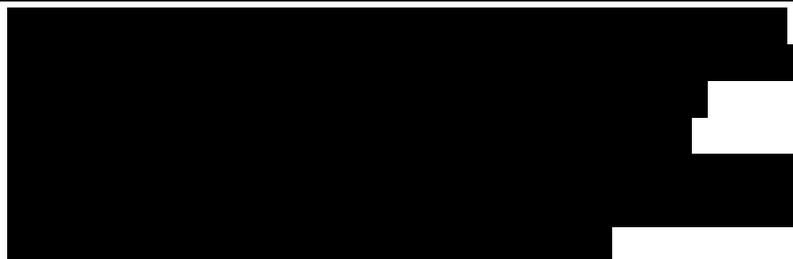
Audit Limitations

Data Limitations – During our audit, we examined Postal Service data, documentation, and other Postal Service records on inbound ETOE shipment volume. We did not audit or comprehensively validate data; however, we noted several control weaknesses that constrained our work. For example, data and other records were incomplete or unavailable, and as a result, we could not readily determine whether charges to the Postal Service by foreign postal administrations were appropriate, or to what extent ETOE activities financially impacted Postal Service operations. Even though data limitations constrained our work, we were able to partially compensate by applying alternate audit procedures, including observation, physical inspection, and discussion with responsible officials.

Legal and Diplomatic Constraints – In addition to the limitations imposed by inadequate records, certain legal, diplomatic, and other considerations restricted our work. For example, we could not access ETOE operations, except in the narrow context of our participation on the Postal Inspection Service task force, and as a result, we could not fully inspect ETOE records, outbound shipments, or accompanying documentation.

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Prior Report  
Coverage



[REDACTED]

- [REDACTED]
- [REDACTED]
- [REDACTED]

During the week  
May 22-28, 2005,  
a Postal Inspection Service  
Joint Task Force  
recovered \$140,000 in  
Postal Service equipment  
from U.S. based ETOEs  
nationwide.

The ETOEs were  
improperly using the  
equipment to transport  
ETOE dispatches  
overseas.

Photograph taken in  
Miami, Florida,  
May 25, 2005.



[REDACTED]

## AUDIT RESULTS

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### Competition and Security

ETOEes are commercial enterprises that compete for high dollar bulk shipments from large customers in major cities. As commercial enterprises, they are not required to service remote or less profitable geographical regions. However, as foreign post affiliates, they access the universal delivery networks of universal service providers at rates intended for national posts. Our audit concluded that ETOEes:

- Take competitive advantage of avenues unavailable to national posts.
- Take competitive advantage of avenues unavailable to shippers not affiliated with national posts.

Our audit also concluded that some ETOE practices are improper—or unauthorized—and that those practices create:

- A vulnerability [REDACTED] the U.S. mailstream.
- Certain unfair financial burdens on the Postal Service.

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### ETOE Use of UPU Documentation and U.S. Mail Transport Equipment

As part of routine business operations, ETOEes accept bulk advertising, letters, correspondence, publications, packages, and other products. ETOEes then consolidate those products, evaluate competitive pricing for transport and delivery, and consign products to the most cost effective transport and delivery channel.

In order to take advantage of UPU rates intended for national postal administrations, ETOEes use UPU documentation. Use of UPU documentation for commercial purposes confers a competitive advantage on ETOEes not available to commercial shippers unaffiliated with national posts.

In order to take advantage of U.S. bulk mail rates, ETOEes sometimes consign bulk shipments to the Postal Service.

[REDACTED] However, use of Postal Service

equipment by ETOEs for purposes other than consigning mail to the Postal Service is unauthorized.

Our audit identified unauthorized use of Postal Service equipment by ETOEs. Specifically, the Postal Inspection Service joint task force, on which we participated, identified unauthorized ETOE equipment use at international airports in New York, Newark, Chicago, Miami, Los Angeles, and San Francisco. In response to unauthorized ETOE equipment use, the task force removed Postal Service equipment which the Postal Inspection Service valued at more than \$140,000.

U.S. Customs and Border Protection agents, Postal Inspectors, and other personnel, stated that ETOE use of UPU documentation and U.S. mail transport equipment

[REDACTED] places certain unfair financial burdens on the Postal Service. They explained:

- Freight shipments with UPU documentation, or contained in equipment bearing universally identifiable Postal Service logos or markings, are easily mistaken for mail, [REDACTED]
- Freight from the United States arriving at foreign destinations in Postal Service equipment can be misidentified as U.S. mail, and result in improper charges to the Postal Service.
- Vulnerability resulting from the misidentification of ETOE freight as U.S. mail could [REDACTED] increase cost to the Postal Service.
- The Postal Service must pay foreign posts for mail transport equipment returned to the U.S. through UPU channels.
- Unauthorized use of equipment bearing the Postal Service logo infringes on the Postal Service brand.

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Department of  
Transportation (DOT)  
Rate Setting

As part of normal business operations, U.S.-based ETOEs routinely analyze competitive air transportation pricing for international shipments to foreign countries. Analyzing competitive pricing on international shipments is a standard

business practice unavailable to the Postal Service—a practice that confers a competitive advantage on ETOEs. ETOEs are free to negotiate rates with all air carriers—both foreign and domestic—and the Postal Service is not. In accordance with U.S. law, the Postal Service must generally use U.S. domestic airlines, and must generally pay rates set by the DOT.

**Virgin Atlantic is a British flag airline.**

**While the Postal Service must generally use U.S. domestic airlines and pay rates set by DOT, ETOEs could negotiate with airlines like Virgin Atlantic for lower rates.**

**Photograph taken at John F. Kennedy International Airport New York, New York, May 14, 2005.**



DOT rates provide airlines with revenues greater than the airlines would achieve in a competitive market. Because data limitations restricted our work, we could not quantify the amount of this overpayment, or validate other estimates. However, our examination of Postal Service, Government Accountability Office, DOT, and congressional documents suggests overpayment exists. For example:

- Proposed 2004 Postal Reform legislation, citing Postal Service data, estimated that the Postal Service could save \$40-50 million annually if the Postal Service was allowed to freely negotiate international air transportation rates with all qualified air carriers.
- The Postal Service has certain very limited exceptions to DOT rates, and when the Postal Service contracts under those very limited exceptions, negotiated rates are usually far less than equivalent DOT rates.
- U.S flag carriers oppose deregulation, cite subsidies received by foreign carriers from foreign

governments, and project U.S. carriers would lose money in a competitive market environment.

Because the Postal Service pays U.S. flag airlines more than competitive market rates on international shipments, ETOEs have a competitive advantage over the Postal Service, and the Postal Service loses potential business.

This situation is illustrated by routine international shipping decisions made by the same U.S. flag airlines that U.S. public policy and law support. During our on-site inspections at international airports and Postal Service facilities, we identified U.S. domestic airline “frequent flyer” statements and advertisements shipped through ETOEs for delivery in foreign countries. The ETOEs were able to successfully compete for this U.S. flag airline business, at least in part, because they were not restricted by the legal requirement to use U.S. domestic airlines—and were allowed to negotiate the most favorable air transportation rate with all available international air carriers—both foreign and domestic.

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Return to Sender

Sometimes ETOE shipments cannot be delivered as addressed. As with mail, delivery failure happens for a variety of reasons. For example, correspondence might be incorrectly addressed, or the addressee may have moved. When ETOE shipments cannot be delivered, shipping instructions may require “return to sender.” When return is required, the return should be made through ETOE channels. However, ETOEs frequently mark shipped items with return instructions too small to be readily identified—or in many cases, ETOEs omit return instructions entirely.

As a result, foreign postal administrations easily misidentify ETOE “return to sender” items as U.S. mail—particularly when the items bear a U.S. return address. For example, during our audit we identified ETOE shipped frequent flyer statements and airline advertising bearing a Dallas post office box return address—and not clearly marked with ETOE return instructions.

Because ETOEs do not properly mark return instructions on items they ship, foreign posts misidentify ETOE return items as U.S. mail; commingle ETOE return items with legitimate mail; and send ETOE return items, as mail, to the Postal Service. In addition—and making identification of ETOE return items even more difficult—the ETOE return items are

sometimes shipped to the Postal Service in U.S. mail transport equipment.

Because ETOE return items are commingled with legitimate mail, sometimes arrive in Postal Service equipment, and are not otherwise easy to identify, Postal Service personnel inadvertently and understandably induct them into the U.S. mailstream for return to shipper. When this happens, the Postal Service bears the cost of using its induction facilities, processing plants, transportation networks, personnel, post offices, delivery networks, and other infrastructure, to return items for which the Postal Service has received no postage. Any Postal Service cost to return ETOE shipped freight is unfair and inappropriate.

This advertisement was sent to Manchester, England, by Global Mail—the Deutsche Post ETOE. The preprinted U.S. “Postage Paid” indicia is marked out and replaced with Royal Mail indicia indicating a London return address. However, the American Airlines return address is more visible, and when Royal Mail could not deliver the item, they sent it to the U.S. Postal Service for return to American Airlines.

We recovered this item at Chicago’s Cardiss Collins Processing and Distribution Center on May 14, 2005.



During our audit we interviewed Postal Service personnel who told us that because ETOE return items were not easy to identify, they were not segregated, and as a result, there was no data to quantify volume. The personnel

Had we not recovered it, Postal Service infrastructure would have been used to return the item to Dallas even though the Postal Service received no postage.

also told us that any process to segregate inadvertently shipped items would be cost prohibitive. Our audit procedures to segregate inadvertently returned ETOE items validated the difficulty of such a process. However, because there was no volume data, we could not estimate

the cost to the Postal Service of using Postal Service infrastructure to return ETOE shipped items.

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## Summary

Because ETOEs have access to UPU documentation and UPU rates; do not have a universal service obligation; and use Postal Service equipment for unauthorized purposes, they have a competitive advantage over official national postal administrations and other commercial shippers not affiliated with national posts. Because ETOEs can negotiate favorable transportation pricing from all international air carriers—both foreign and domestic—and are not restricted to using U.S. domestic airlines at rates set by the DOT, ETOEs have an unfair competitive advantage over the Postal Service. Finally, ETOE use of UPU documentation, and unauthorized use of U.S. mail transport equipment, disguises ETOE freight as legitimate mail, [REDACTED] places unfair financial burdens on the Postal Service.

To help resolve these issues, the Postal Service would need to work with Congress; the Departments of State, Justice, Commerce, and Homeland Security; the Universal Postal Union; and other national postal administrations, to establish law, regulation, and procedure which:

1. [REDACTED]
2. Eliminates the unfair advantages ETOEs have over the Postal Service, including anticompetitive restrictions which compel the Postal Service to transport international mail on U.S. domestic airlines at rates set by the Department of Transportation.
3. Eliminates the unfair advantages ETOEs have over international transport and delivery businesses not affiliated with foreign posts, including the elimination of ETOE use of Universal Postal Union documentation and indicia.

