

Comments on the Report by Diversified Specifics<sup>1</sup>  
“Domestic Letter Segment Forecasts”

Michael A. Crew<sup>2</sup>  
Paul R. Kleindorfer<sup>3</sup>

March 12, 2010

Any discussion of demand in the postal sector takes place against a complex backdrop of fundamental changes occurring in the sector worldwide. The driving force is undoubtedly the changes that have been occasioned by increased competition, first by the emergence of substantial private express companies in 1980s and second, and by the evolution of the Internet and related electronic services in the past decade. Electronic competition, in particular, means that POs are facing declining demand for the letter mail and transactions mail (e.g., from financial institutions and utilities). Declining letter mail volumes were becoming evident in the past few years in terms of slowing growth in letter mail volumes. This slow growth has turned into significant declines – in some cases double-digit declines - because of the financial crisis which began in 2007 and from which we are just now emerging.<sup>4</sup> The most worrying aspect of this is that, rather than sporadic demand fluctuations, these declines may be the result of new patterns of consumption, which may well continue into the future.

Around the world the story is the same: electronic substitution, the financial crisis, changing mailing and advertising patterns, and a continuing requirement and public expectation to provide universal services.<sup>5</sup> Against this background, the issue of understanding responses of customers to service specifications and to pricing is clearly of fundamental importance. To provide useful information, it is critical to analyze postal demand on the customer segment level.<sup>6</sup> In this sense, the Diversified Specifics study reviewed here is timely and appropriately focused on responses to postal product offerings by individual market segments. In doing so, Diversified Specifics builds on its earlier work on postal demand forecasting in Australia, but they also add significant new features to this previous work in the present study. Most importantly, following recent trends in econometrics, the

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<sup>1</sup> These comments are provided at the request of Chris Paterson of Diversified Specifics. They represent the opinions of the authors and not necessarily those of Diversified Specifics.

<sup>2</sup> CRRRI Professor of Regulatory Economics, Rutgers University, [m.a.crew@verizon.net](mailto:m.a.crew@verizon.net)

<sup>3</sup> Paul Dubrulle Professor of Sustainable Development, INSEAD, [paul.kleindorfer@insead.edu](mailto:paul.kleindorfer@insead.edu)

<sup>4</sup> These volume declines are in evidence in almost every postal operator worldwide. For example, for the United States Postal Service (USPS), mail volume fell 12.4%, from 202.7 billion in 2008 to 177.1 billion mail pieces in fiscal year 2009. Over the same period, USPS operating revenues declined 9.1%, from \$74.9 billion to \$68.1 billion, with resulting operating losses in 2009 of \$3.8 billion.

<sup>5</sup> For a recent survey of major developments around the world in postal reform in balancing these issues, see Crew, Kleindorfer and Campbell (2008).

<sup>6</sup> For a survey of recent pricing practice, and underlying principles of marketing science applied to postal products, see Kleindorfer and Szirmay (2009).

models studies are based not only on the standard historical drivers of demand (including prices, substitutes and the level of economic activity), but they also allow for the introduction of non-stationary exogenous factors that may well affect the future of mail demand in Australia. The introduction of such mixed models (combining historical data with scenario-based data of economic and sectoral changes that might be expected in the future) is clearly important since, as noted above, the postal sector is going through a period of considerable change at this time.

The general approach pursued in this study is similar to the methodology undertaken by Boldron et al. (2010) for France. This approach allows the modeler to postulate and test for possible long-run relationships that might exist between several underlying demand factors. If such a long-run relationship exists, and is not accounted for in the modeling, then spurious regression results obtain in which, in particular, estimates of price elasticities and statistical significance levels can be misestimated. The approach taken to test for cointegration (i.e. additional long-run relationships) between factors such as price, economic activity and substitute goods is therefore both in keeping with advances in econometrics as well as reflecting the very real possibility of nonstationary changes occurring in postal markets and underlying the factors driving postal demand.<sup>7</sup> Added to these econometric results, the authors also investigate possible additional drivers that might further affect postal demand going forward. This approach of gathering and structuring both judgmental factors, that might condition demand in the future, as well as recognized economic drivers of demand, is appropriate in the current context of the fast changing postal market.

What Diversified Specifics provide in their segment-specific modeling and analysis is a credible basis for understanding differentiated trends among various postal products. For example, their findings on small letter segments separate out the effects of electronic substitution on bill presentment and transactions mail from pricing effects and overall secular declines affecting the category of small letter segments as a whole. This is the sort of detailed structural information that can contribute to a better understanding of the differentiated impacts of the level of economic activity (not under control of Australia Post) and pricing policies (under its control). Using state-of-the-art econometrics Diversified Specifics' resulting detailed assessments of mail volumes and price elasticities of products, by customer segment, therefore provide a grounded and credible basis for action, particularly in light of the changing economic conditions.. Given the serious volume declines facing POs the Diversified Specifics Report provides an important contribution to assist POs generally and Australia Post in particular, in taking appropriate actions in the light of the decline in demand. It does not provide, nor can it be expected to, a

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<sup>7</sup> While we are supportive of the methodology used in this Report, we have not reviewed the details of the econometrics in the Diversified Specifics Report, nor the data underlying this study. Our comments here refer to the appropriateness of the methodology used and the logical coherence of the arguments derived in the Report from this methodology.

solution to the problem of stemming the declining demand, but it does provide some of the underlying analysis that will be necessary to address the problem.

## **References**

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