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POSTAL REGULATORY COMMISSION
WASHINGTON, D.C. 20268-0001

PRICE ELASTICITIES AND INTERNET DIVERSION	Docket No. RM2014-5

COMMENTS OF THE NATIONAL POSTAL POLICY COUNCIL
IN RESPONSE TO NOTICE OF INQUIRY NO. 1
(August 28, 2015)

The National Postal Policy Council ("NPPC") respectfully submits these comments in response to Notice of Inquiry No. 1 (June 12, 2015) ("NOI 1").

NOI 1 asks for suggestions regarding possible improved inputs into an econometric demand model. While the questions themselves are reasonable from a theoretical perspective, the NOI puts the cart before the horse. Instead of immediately looking to identify possible new factors, a more useful next step would be to conduct an appropriate survey of mailers to obtain a better understanding of how they go about making mailing decisions. That should provide a sounder basis for identifying relevant factors to use in volume demand and forecasting models, and should result in improved estimates of diversion and price elasticities.

In addition, such a survey might shed useful insights about demand at a time when the lack of material change in real postal rates over the past decade means that the current model cannot be trusted to produce reliable forecasts beyond the range of price changes for which it is fit. And because the uncertainty in the estimate only increases as one moves further beyond that

range, it is important to obtain from mailers directly an understanding of how they could be expected to respond to material changes in real rates.

I. BACKGROUND

The Commission initiated this proceeding in response to a petition filed by NPPC and seven other parties.[1] That petition observed that the estimates of price elasticity generated by the Postal Service's demand model for First-Class Single Piece, First-Class Presort Mail, and Standard Mail appeared to vary widely from those found by empirical research on how mailers make decisions. It also noted that despite acknowledging that electronic diversion is a principal cause of volume declines, the Postal Service has for years struggled to factor electronic diversion into its demand models.

The Commission's first step in response to the Petition was to schedule a technical conference at which was presented a paper co-authored by Lyudmila Bzhilyanskaya, Margaret Cigno, and Edward Pearsall (attached as Attachment A to Order No. 2117). In subsequent comments on that paper, NPPC said that the "Branching" model presented therein offers potential for improvement over the current model because it demonstrates an ability to estimate price elasticities at the product and shape levels. NPPC also added that the related "Trunk" model – which is based on the prevailing model -- might no longer provide the Postal Service and Commission with accurate information regarding price elasticities and electronic diversion. NOI 1 is the most recent step in this proceeding.

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[1] Petition To Improve Econometric Demand Equations for Market-Dominant Products and Related Estimates of Price Elasticities and Internet Diversion (May 2, 2014).

II. A SURVEY OF HOW MAILERS MAKE DECISIONS SHOULD BE CONDUCTED BEFORE IDENTIFYING WHAT FACTORS TO INCLUDE THE DEMAND MODELS

The Branching model presented in 2014 offers promise insofar as it suggests that price elasticities can be assessed on a product-specific basis, or even more finely. NOI 1 builds on the 2014 paper by seeking to identify more relevant factors to use, an important goal given that current models fail to address directly a factor as significant as electronic diversion.

Nonetheless, NPPC believes that attempting immediately to identify new factors to improve the econometric model is premature. Econometrics is an exercise in judgment, and that judgment should be based on a well-grounded understanding of mailer behavior. NPPC submits that the most probative way to identify the relevant factors to test in future modeling would be to conduct empirical research into how mailers make decisions.

To do so, the Commission should conduct a sound quantitative and qualitative analysis of mailer behavior, including how they make mailing decisions.[2] This effort should produce a modeling of mailer behavior, based on interviews and surveys. The petition that initiated this proceeding outlined (at 14-16) the basic steps such an effort could take.

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[2] From time to time the Postal Service has commissioned research that made at least some use of mailer surveys, but to NPPC's knowledge has not done so in a comprehensive way or used those results to inform its demand model. *E.g.,* OIG, "*What America Wants and Needs from the Postal Service: Summary of Focus Group Research"* (Feb. 18, 2014); OIG, *"What American Wants from the Postal Service: A Survey of Internet-connected Americans,"* (RARC-WP-13-009 (May 21, 2013); Direct Testimony of Greg Whiteman, Docket No. N2012-1; Boston Consulting Group, *"Projecting US Mail volumes to 2020* (Mar. 2, 2010). The projections on the BCG report appear reasonably accurate to date.

Obtaining information directly from mailers would also be desirable for a second reason. NPPC notes that real prices for market-dominant postal products have changed little since 2006, even after the 4.3 percent exigency surcharge approved in Docket No. R2013-11 is taken into account. One consequence of that stability in real postal rates over nearly a decade is that price elasticities useful in estimating volume changes caused by larger price increases cannot be reliably determined from the data. When little real price change has occurred, it is not possible to calculate meaningful price elasticities that have any reliable application to price changes far outside of the range of the input variables.

Although real postal rates changed little between 2006 and 2015, the communications marketplace in which the Postal Service operates experienced tremendous changes throughout that period in broadband and wireless communications – highlighted by the introduction of the iPhone, tablet computers, fiber optics, widely available wireless broadband services, and social media. The effect of these technological innovations on mail is not well understood, and does not appear to be reflected well in current postal demand models. That makes it all the more imperative to develop an improved understanding of how mailers today make mailing decisions. And the best way to do that is to talk to them directly.

With this background, NPPC responds to the questions in the NOI as follows:

Questions 1 through 3 ask about the Branching AIDS Model. In general, NPPC supports efforts to estimate price elasticities at the product and shape level and beyond. Indeed, ideally the Postal Service's demand model should be sufficiently robust that elasticities could be calculated for any particular mailer.

Question 1a asks: "What, if any, assumptions regarding mailers' behavior, either included in the Branching AIDS Model or otherwise, should be incorporated into the postal demand and forecasting models and why?" Similarly, **Question 1b** asks what other factors affecting mailing choices should be reflected in the models.

As noted above, NPPC suggests that, rather than engaging in abstract speculation about possible factors, surveying a representative sample of mailers would be more likely to lead to accurate and useful conclusions about the "factors affecting mailing choices." In response to **Question 2d**, either the Postal Service or the Commission could conduct this survey.

Such an investigation could be particularly valuable because some of the assumptions in the Branching model seem contrary to mailer behavior. For example, the Branching model distributes a certain postal "spend" among postal products. In that model, the choice of shape is the last decision point facing a mailer. In fact, the shape of a mailing often is the first decision a mailer makes. NPPC also is skeptical that First-Class mailers divide their expenditures by class without knowing how they will be sub-divided by category, as the Branching model assumes. NPPC members, at least, are quite aware of the postage prices that they will be charged at every stage of the decision-making process.

Question 4 asks about electronic diversion. This is a very important line of inquiry, because diversion is the leading cause of volume declines. It is difficult to say, *a priori*, whether factors such as measures of smartphone penetration, broadband connectivity, and (separately) wireless broadband connectivity over the past decade would produce useful results.

This is an area in which understanding why mailers choose between mail and digital options may shed light on what might prove to be useful factors. For example, NPPC members report anecdotally that they often evaluate their mail and digital channels for many purposes interactively – not independently. Thus, in deciding whether to spend on mail or digital channels, they appear to consider simultaneously factors such as price, their understanding of customer demand, the return on investment for each channel (*i.e.*, the effectiveness in obtaining remittances), non-price costs of each channel, and other factors. A survey could confirm not only that this happens, but also collect insights into the degrees to which these factors weigh on their decisions, which in turn could help to identify useful factors for econometric modeling.

Question 5 asks about the effects of indirect competitors on postal demand. Again, this is a topic on which empirical research on mailers might provide a factual basis for proceeding.

Question 6 asks about an alternative model that models the postal demand of different consumer groups separately. NPPC agrees that different

groups of mailers have different demand for postal services, a fact shown by its own past mailer research.[3] Modeling the demand of each group offers promise of improved understanding, and may lead ultimately to more mailer-specific demand models in connection with negotiated services agreements.

Question 7 asks about the possibility of estimating price elasticities on a geographically disaggregated basis. This should be a lower priority. NPPC doubts that such an analysis would have much value unless postal rates were also disaggregated geographically, which seems unlikely at the present time (and on which NPPC takes no position at this time).

III. CONCLUSION

For these reasons, the National Postal Policy Council urges the Commission to undertake a comprehensive survey of how mailers make mailing

[3] *See* Statement of Lawrence G. Buc of SLS Consulting, Inc., Docket No. R2013-11 (filed Nov. 26, 2013). That research suggested that the price elasticities of First-Class Presort and Single-Piece mail, and of Standard Regular, are far more price sensitive than the Postal Service's econometric demand model indicates, and close to elastic levels.

decisions in order to develop a better understanding of their processes before adopting *assumptions* to use in econometric models.

Respectfully submitted,

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