Discussion of « The effect of Flexible Pricing on Entry Into the US Letter Market », Robert Cohen and Charles McBride

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Sixth conference on "Regulation, competition and universal service in the postal sector"

Objectives and methodology

The objective of the paper is to calculate the value of USPS legal monopoly

- **Very Few studies address this issue, literature more focused on the cost of the universal service**
  - When universal service is financed by a subsidy, the European commission controls that the subsidy is not superior to the cost of the mission
  - When universal service is financed by a reserved area, there is no systematic comparison between the value of the monopoly and the cost of the USO.
- **However, this issue of the value of the monopoly should be central:**
  - Regulatory perspective: Assessing the financing needs of the USP after liberalization.
  - Business perspective: What will be the result of entry on the volumes and profits of the incumbent? What are the possible answers (pricing strategies) of the incumbent to entry?

The paper adopts an “Entry Pricing” methodology:

- **“Entry Pricing” was sometimes used to calculate the cost of the universal service, the paper makes it clear that “Entry Pricing” is actually a method to calculate the value of the monopoly.**
- **The “Entry Pricing” method compares the profits of the incumbent with a monopoly to the profits without this monopoly. The scenario without monopoly has to simulate entry by a competitor.**
- **The competitor skims the contestable mail on routes where he can be profitable while proposing a price low enough to attract demand.**

Main results

- **Without price reaction of USPS, the value of the monopoly in the base case is 2.48 billions $**

- **With price flexibility**
  - USPS can reclaim most of the lost routes by decreasing its prices on the skimmed routes.
  - USPS can recoup its lost profits by increasing its prices on unskimmed routes. Liberalization (with price flexibility) can even increase the profit of USPS.

- **Use of La Poste profit curve**
  - When using La Poste distribution of Profit by route, the entrant can skim 57 744 routes against 45 505 in the American case. And more important, price flexibility only permits to reclaim 29 252 routes against 39 289 in the American case.
  - These results are in line with the entry model developed by Cremer, Florens, Grimaud, Marcy, Roy and Toledano (2001) for France: Price flexibility on contestable mail is not sufficient to recoup looses.

- **These results are very dependant on the value of some input variables. But the authors provide important results on sensitivity analysis. By order of importance, input variables are:**
  1. The size of the contestable market
  2. The number of distributions of the entrant in a week
  3. The cost and the price of the entrant

Possible additional scenarios

PRICE FLEXIBILITY SCENARIOS

- **The study of the value of the monopoly with price reaction is interesting and politically relevant.**
- **However it does not focus anymore on the value of the monopoly, since there is a change in regulation and maybe even USO (is the price still affordable after the increase?).**
- **Two other scenarios focusing more on the monopoly value could be studied**
  - Comparing actual profits to profits in a case where USPS can not increase prices, but can decrease prices on the routes skimmed by the incumbent.
  - Comparing profits in a situation with monopoly and price flexibility to the profits in a situation without monopoly with price flexibility.

PROFITABILITY OF THE ENTRANT

- It would be interesting to indicate the profit of the entrant
- In the US where entry seems difficult (especially when USPS has price flexibility), would this profit be high enough to cover institutional costs?

Some questions and comments about the hypotheses

SIZE OF THE CONTESTABLE MARKET

- ***Hypothesis***: Entrant has no upstream infrastructure. Entrant can only deliver workshared mail
- ***Hypothesis***: The volume of workshared mail will be the same before and after entry
- But, it seems that a mailer could choose to loose money on the upstream market, using a third party (less efficient and more expensive than USPS) to do the upstream activities, in order to benefit from the discounts of the entrant on the delivery market. Volume of workshared mail would thus increase after entry?

VOLUME LOSS BY THE INCUMBENT

- ***Hypothesis****:* when profitable, the entrant skims the whole contestable market
- Authors acknowledge that this is not what is observed in liberalized markets, incumbent retains part of the contestable volume
- Explanation of the authors: Inertia, brand effects… If this explanation is the good one, the model still gives the good results in the long term
- Alternative explanation: Products of the entrant and incumbent are differentiated [chosen by Cremer and al. (2001)]. If this explanation is the good one, the model will lead to inflated estimations of volume loss.

EQUILIBRIUM IN THE SCENARIO WITH PRICE FLEXIBILITY

- ***Hypothesis***: The entrant has to offer a discount to attract demand
- ***Hypothesis***: The incumbent increases (unskimmed routes) or decreases (skimmed routes) its prices to the level of the entrant cost.
- If the entrant has to offer a discount on the incumbent price to attract demand, USPS should be able to set a price superior to the cost of the competitor without loosing the route?

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