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The Effect of Flexible Pricing on Entry into the US Letter Market

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Outline

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Introduction

- Test the hypothesis that flexible pricing would greatly limit an entrant's ability to capture volume
- Based on an entry point model developed for an earlier PRC staff study

The Model

- US has a competitive upstream market
- We need only examine the delivery market
- Based on USPS data for delivery routes
- Looks at the contestable mail on each route to see if entrant could profitably deliver the contestable mail on the route
- Entrant's variable and fixed cost is 90 % of USPS (base case)

Sensitivity of Model to Input Variables

Input Variable	Range of Values	Range of Monopoly Values (\$billions)
Entrant's Discount	0%-20%	\$3.9-\$3.1
Delivery Days/Week	1-6 Days	\$5.1-\$1.6
Cost Advantage	0%-30%	\$3.1-\$4.3
Contestable Volumes	50%,100%, 150%	\$0.8-\$5.9

Contestable Volumes

- Based on USPS worksharing data
- Mail that is carrier route presorted and drop shipped at the SCF or DDU (about 30 miles of entrant) is contestable
- If not, it was cheaper to hand it over to the USPS at an upstream stage
- 55 billion pieces of contestable mail or 26% of total volume

Impact of Pricing Flexibility (1)

- We will think of it as a 2 step process
- First the entrant skims routes
- The USPS then adjusts its prices only on contestable mail
- Upwards on loss making routes, about 30% max
- Downwards on profitable routes, about 50% max

Impact of Pricing Flexibility (2)

USPS profit loss (\$bil)	Max price change	Gain from Flex Prices (\$bil)	Initial skimmed routes	Reclaimed Routes	Inefficient Skimmed Routes
2.48	10%	0.46	45,505	10	33,252
2.48	30%	1.68	45,505	27,917	8,125
2.48	50%	2.36	45,505	39,289	1,171

Sensitivity to Contestable Volume

USPS Profit Loss from Skimming	Percent of Contestable Volume	Maximum Price Change (%)	Total Gain from Flexible Pricing	Initial Skimmed Routes	Reclaimed Routes
1.38	75	10	0.57	23,500	0
1.38	75	30	1.71	23,500	14,719
1.38	75	50	2.51	23,500	18,311
0.50	50	10	0.66	8,480	0
0.50	50	30	1.92	8,480	4,119
0.50	50	50	3.01	8,840	4,119

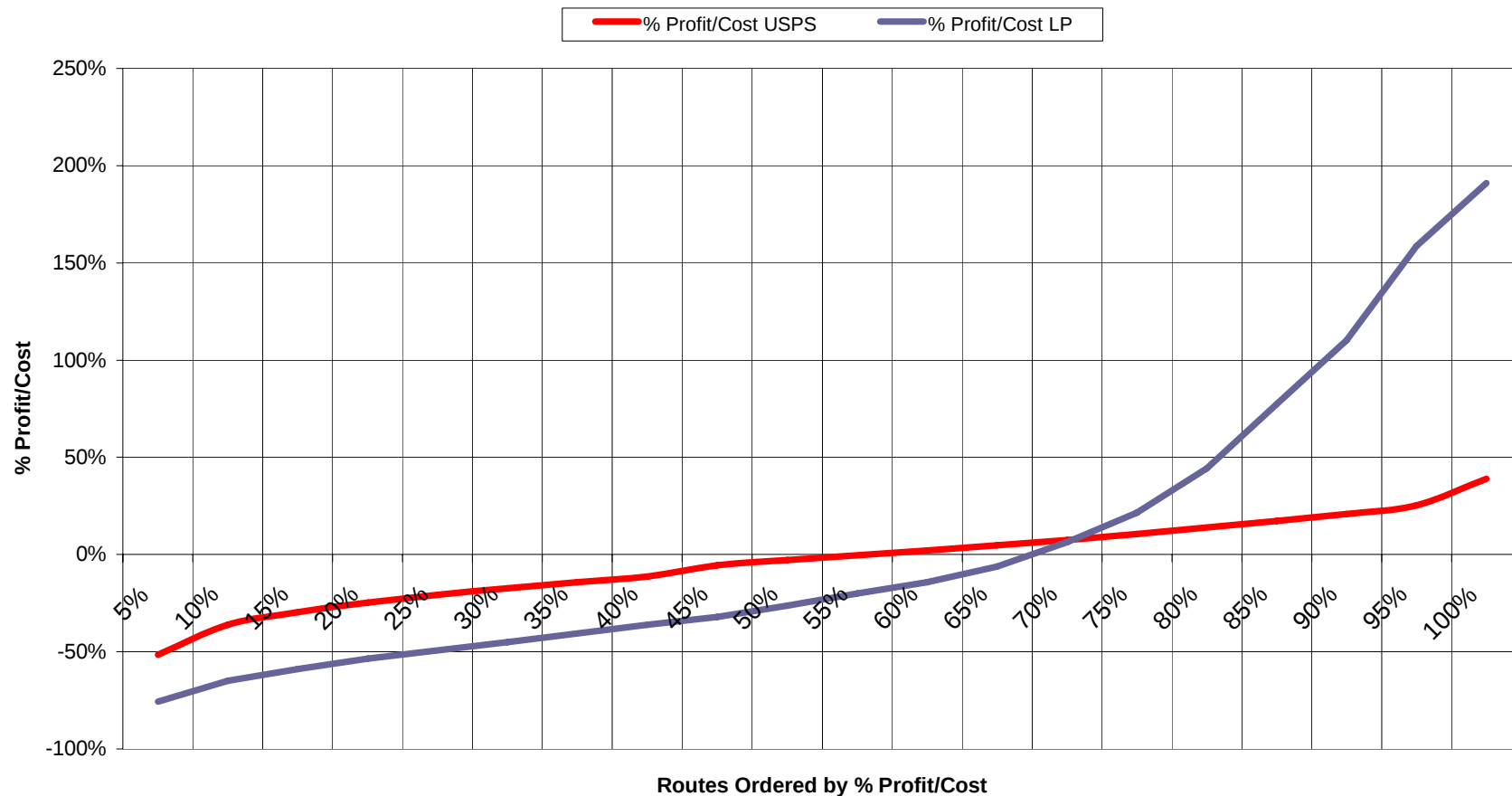
Sensitivity to Delivery Frequency

Frequency	USPS Profit Loss from Skimming	Percent of Contestable Volume	Maximum Price Change (%)	Total Gain from Flexible Pricing	Initial Skimmed Routes	Reclaimed Routes
2 Days	3.27	100	10	0.34	72,264	0
2 Days	3.27	100	30	1.55	72,264	45,947
2 Days	3.27	100	50	2.15	72,264	70,447
1 Day	3.97	100	10	0.12	152,958	59
1 Day	3.97	100	30	0.85	152,958	59,944
1 Day	3.97	100	50	1.46	152,958	143,614

Profit Curves

Figure 1. % Profit/Cost of USPS Routes versus LP routes

Profits normalized. Volumes of La Poste do not include "delivery" via PO boxes (firm holdouts) and "B&A routes".



Flexible Pricing Results for La Poste and USPS

Post	Profit Loss	Total Gain from Flexible Pricing	Initial Skimmed Routes	Reclaimed Routes	Inefficient Skimmed Routes
La Poste	3.11	2.16	57,744	29,252	27,897
USPS	2.48	2.36	45,505	39,289	1,171

Conclusions

- ***Flexible Pricing***: The entrant can reduce losses from \$2.48 B to \$0.1 B and loses 0.5% of routes in the base case
- The fewer the constraints placed on flexible pricing, the fewer ***inefficiently skimmed*** routes there will be.
- When only 75% or 50% of ***contestable*** volume is available, the incumbent can increase profits with flexible pricing

Conclusion Continued

- When entrant *delivery frequency* is 1 day per week, incumbent's lost profit is \$3.97 b and 60% of routes are skimmed.