

The Relationship Between Newspaper Costs & Predation Lawsuits

by Robert G. Picard

Newspaper managers must be aware of the costs of producing their papers if they are to make informed decisions in setting prices and avoid charges of "predatory pricing" from competitors. Here are some suggestions for figuring price structures.

Increasingly, newspapers find themselves defendants in predation lawsuits by competitors — more than two-thirds of all newspaper antitrust cases filed in the 1980s involved predatory pricing.¹ These lawsuits, pitting daily newspapers against competing dailies and dailies against weeklies, most often concern predatory practices in newspaper advertising and circulation sales.²

If newspaper managers with authority to set prices, particularly in competitive situations, had a better understanding of how courts analyze costs, many such predation lawsuits might be avoided.

Most newspaper managers are unaware of the importance of the cost analyses used in legal determinations of whether predation has occurred. Such analyses can be used to avoid litigation when setting advertising and circulation rates as part of a newspaper's competitive strategies.

Cost analyses are most commonly used when charges of predation — "predatory pricing" — are lodged against a newspaper company. Predation is prohibited in Section 2 of the Sherman Act³ and involves selling a product below cost with the intent to monopolize a market by underpricing competitors, which results in at least a probable reduction in competition.⁴

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Newspaper managers regularly set prices for circulation and advertising space with the idea of covering total costs and creating a profit, but this casual approach is dangerous when engaging in price-cutting activities as part of competition with other media products. A newspaper manager who lowers classified, retail or national ad rates to attract advertisers from another paper, or who lowers the price of subscriptions or single copies for the same purposes, must do so as a fair competitor.

If the cuts appear to be below cost and a competitor is harmed by the price cuts, that competitor or a government antitrust enforcement agency may begin lengthy and expensive litigation alleging predatory pricing. In order to protect one's newspaper, the manager in charge of pricing should have a clear understanding of how the price cuts relate to the costs of the product. Otherwise, the manager can make the paper vulnerable to charges of predation if the discounts or price reductions lower the paper's production price below cost.

Unfortunately, such knowledge is noticeably lacking in the newspaper industry. A recent study of newspaper circulation managers found that only a third knew the cost of producing their papers for sale to subscribers or single copy purchasers.⁵ Newspaper advertising managers have been shown to be uninformed about the relation of costs to rate-setting and also have been shown to set prices based on hunches rather than on economic principles and data.⁶ But despite this general lack of attention to and understanding of cost and price issues, there is evidence that some large public newspaper companies are starting to pay attention to costs when making production rather than pricing decisions.⁷

Understanding these issues is critical. Regardless of the size of the paper, newspaper managers in competition with other newspapers and media products must be aware of their costs when setting prices for advertising or circulation to ensure that they do not place their newspapers at risk of litigation when they engage in vigorous competition.

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Testing Predation Charges

The goal of antitrust law is to ensure consumer benefit by halting practices that harm competition. Predation, while lowering consumer costs in the short run, results in long-term harm if the practice reduces competition and thus allows the predatory company to increase prices without fear of competition. Although it is possible to employ economic theory for highly sophisticated analyses of effects of any price change on a market, it is nearly impossible to acquire sufficient cost data from competing firms and the market as a whole to employ these analyses.⁸

Antitrust law seeks to ensure consumer benefit by halting practices that harm competition. Predation, while lowering consumer costs in the short run, results in long-term harm if the practice reduces competition and thus allows the predator company to increase prices without fear of competition.

As a result, federal courts and many state courts have adopted a less sophisticated but usable standard, the Areeda-Turner Test.⁹ This test relies on calculations of average variable costs (AVC) and asserts that prices above AVC are acceptable but that prices below AVC are

predatory if accompanied by intent to harm and by demonstrable harm to competition.

In order to calculate AVC, a firm's costs must be broken down into two categories: fixed and variable. Fixed costs are those for production that are not changed in the short run to increase or decrease the amount of product produced.¹⁰ Variable costs are those that directly affect the amount of product when their quantity is varied. These costs vary from industry to industry and from firm to firm. There is sometimes disagreement over which costs are in fact fixed and which are variable.

In the newspaper industry, fixed costs generally are accepted to be the nonprinting expenses, including the costs for facilities and equipment and the general costs of operating a newspaper.¹¹ Newspapers' financial statements vary in the ways they report costs, and it is sometimes necessary for expenses of various departments be broken out for use in calculating costs.

Variable costs are those that change with quantity of production. These

TABLE 1: Fixed & variable newspaper costs

Fixed Costs	Variable Costs
Buildings and land	Newsprint
Equipment	Ink
Basic editorial costs	Plates and supplies
Basic circulation costs	Outside printing
Basic administration costs	Purchased sections
Basic production costs	Additional printing labor*
Basic promotion costs	Additional circulation labor*
	Additional circulation supplies*
	Additional advertising labor*
	Additional advertising supplies*
	Additional editorial labor*
	Additional editorial supplies*
	Additional administration labor*
	Additional administration supplies*
	Additional promotion labor*
	Additional promotion supplies*
	Additional buildings and land*
	Additional equipment*

*Normally considered variable only as long-run costs

costs are well recognized in newspaper accounting.¹² The two most significant contributors to variable costs are almost always reported in newspapers' financial statements: ink and newsprint. Other important elements, such as plates and related supplies and ad commissions, often are not reported as fully. If the number of page changes or the number of copies produced changes, these become important in calculating costs. Often, costs must be extrapolated or estimated. Typical fixed and variable costs for newspaper production are shown in Table 1.

Assuming a constant scale for a newspaper's fixed costs — that is, that increasing the number of papers produced or the size of the papers produced does not increase fixed costs by requiring facilities or press expansion, or more administrative, advertising, or editorial personnel, supplies or equipment — the fixed costs are established easily by taking figures from budgets or profit/loss statements.¹³

Establishing variable costs, however, is a little more complicated because they are influenced by the manner in which a change is made — the number

of copies produced or the number of pages produced.

Each has different variable costs. If the number of copies changes, one generally is faced only with changes in the costs of newsprint, ink and, sometimes, printing supplies. If the number of copies produced changes significantly, production and circulation labor, supplies and equipment may change as well. For example, increasing a press run by 50,000 will require more printing labor, plates, printing supplies, circulation labor, supplies, trucks, etc. But an increase of 5,000 may result in no significant change in such items.

In order to adjust for the normal variations in daily and seasonal sizes and quantities produced by a paper, variable costs are averaged over time, using average daily circulation figures when attempting to establish them for analysis purposes.

Calculating Newspaper Costs

Because of wide differences in newspaper sizes and in accounting methods used by newspapers, there is no universally accepted newspaper industry method for calculating costs. Two well-accepted approaches have been suggested, however, for use in profitability analyses of newspapers, by the Institute of Newspaper Controllers and Finance Officers (now the International Newspaper Financial Executives Association).¹⁴ This article will review and contrast three usable methods for applying such cost analyses to issues of predation, drawing upon the two calculation methods suggested by the industry association.

Clearly, increasing a press run by 50,000 will require more printing labor, plates, printing supplies, circulation labor, supplies and trucks. But an increase of 5,000 may result in no significant change.

As indicated, a newspaper's fixed costs can be established by adding all costs not directly associated with the printing of the paper itself, if scale does not become an issue. The remaining costs are then added to create variable costs. How one uses and interprets

these costs is crucial, however, and depends on whether a newspaper is viewed as a single or dual product.

SINGLE-PRODUCT COST CALCULATION: In this approach, the entire newspaper is handled as a single product. No attempt is made to separate the revenue streams or costs associated with producing the paper to serve advertisers or readers. If one employs this method to determine whether prices are predatory, for instance, the only issues are whether variable cost, adjusted to single copy cost, equals or exceeds sales revenues. If the income from advertising and circulation for the single copy exceeds the cost of production and distribution, predatory pricing would not be shown.

In making this analysis, one calculates average fixed costs (AFC) by dividing the annual expenditures on nonprinting costs by average circulation. Use Table 2 data on the next page as an example. Assuming average daily circulation of 60,000 and using the data from the sample income and expense statement, the average fixed cost for an issue of the paper is 46.8 cents (calculated this way: Fixed Expenses (\$10,237,598) divided by 365 days divided by Circulation, in this case, 60,000 copies).

Having established the average fixed costs, one then turns to the important average variable costs (AVC). Average variable costs are calculated by dividing total variable expenses by output. In this example in Table 2, variable costs or expenses of newsprint + ink + plates, etc. (\$5,299,171) divided by circulation days (365), divided by circulation (60,000) = average variable costs of 24.2 cents.

By adding the average fixed costs and average variable costs — in this case 46.8 cents and 24.2 cents — average total cost is 71 cents. It thus costs 71 cents to produce an average copy of the paper. If a paper receives less than 24.2 cents (the AVC) in revenue from advertising and circulation for the copy, its price is in the region in which predation could be alleged. Obviously, a newspaper would not choose to produce at such a rate of revenue and expense for very long, but there is evidence that competing papers in Little Rock and Detroit recently have done so.¹⁵

Although this single-product calculation approach provides a usable managerial view of costs, it is a weak and inappropriate method for most predation analyses. Litigation usually involves only one of the newspaper products — advertising space or circulation — and thus the fixed and variable costs must be separated and attributed to the specific product involved. Table 3 summarizes the strengths and weaknesses of each approach.

TABLE 2: Sample Income & expense statement

REVENUES		
Advertising		
Local	\$8,450,132	
National	1,975,001	
Classified	4,224,500	
Preprint	542,677	
Subtotal	\$15,192,310	(78.3%) (74.6%)
Circulation		
Subscription	\$3,459,862	
Single Copy	754,132	
Subtotal	\$4,213,994	(21.7%) (20.7%)
Total Ad & Circulation Revenue	\$19,406,304	
Other	\$965,668	(4.7%)
Total Revenue	\$20,371,972	
EXPENSES		
Production	\$2,321,111	(14.9%)
Newsprint*	4,532,784	(29.2%)
Ink*	578,931	(3.7%)
Plates etc.*	187,456	(1.2%)
Advertising	1,255,334	(8.1%)
Circulation	1,954,779	(12.6%)
Editorial	1,734,598	(11.6%)
Administration	1,378,422	(8.9%)
Promotion	479,002	(3.1%)
Building and Land	769,554	(5.0%)
Equipment	344,798	(2.2%)
Total Expense	\$15,536,769	
Net Income Before Taxes and Adjustments	\$4,835,203	
Total Expenses	\$15,536,676	
Variable Expenses	- 5,299,171	
Fixed Expenses	\$10,237,598	

*variable expenses

DUAL-PRODUCT COST CALCULATION: Dual-product cost calculations begin by using the basic AFC and AVC calculations outlined above in the single-product approach. But this kind of analysis recognizes that the dual products of newspapers provide two straightforward calculations of variable cost that can be used in providing analyses for antitrust actions and in making many more sophisticated business decisions as well.

This approach allocates costs based on the separate products recognized in cost allocation by the newspaper financial executives group.¹⁶ Thus, instead of providing average fixed and variable costs for the entire newspaper, these analyses produce measures of AVC for advertising and AVC for circulation.

The first dual-product calculation splits total cost between the two products based on the percentage of revenue received from advertising and circulation. In determining whether revenue exceeds cost, the proportioned AVC (advertising) is compared with ad revenue and the proportioned AVC (circulation) is compared with circulation cost.

Using data from the sample in Table 2, the total AVC of 24.2 cents would thus be proportioned between advertising and circulation. Regarding the "other income" (usually job printing or extraordinary income), the income and expense statement in Table 2 reveals that 78.3 percent of revenue comes from advertising and 21.7 percent from circulation. Thus, 18.9 cents of the AVC (78.3% of 24.2 cents) is attributable to advertising and 5.3 cents (21.7% of 24.2 cents) to circulation.

Using this method, the paper would be vulnerable to predation charges if it did not receive at least 5.3 cents in circulation revenue for each copy sold or 18.9 cents in advertising revenue for each copy distributed.

This method, however, suffers from a significant weakness in that advertising income may cross-subsidize circulation costs or circulation income may subsidize advertising costs.¹⁷ Proportioning costs based on revenue, then, will assign costs erroneously if such subsidies exist.

In order to account for this difficulty, a second dual-product calculation approach utilizes a content, rather than revenue, measure to determine how to proportion AVC between the two products. Use of such an approach in cost finding is recommended in a standard newspaper management text and used in cost analyses recommended by the newspaper finance association.¹⁸ Thus, if 68 percent of the content of the newspaper is advertising lineage, 68 percent of the AVC are attributed to advertising and 32 percent to circulation. In the sample paper in Table 2, 16.5 cents (or 68.2 percent) of

the AVC (24.2 cents) is attributable to advertising and 7.7 cents (or 31.8 percent) to circulation. The paper would be vulnerable to predation charges if it did not receive at least 7.7 cents in circulation revenue for each copy sold or 16.5 cents in advertising revenue for each copy distributed.

This content-based assignment of costs is superior to revenue-based assignment and the best available method for cost analysis. Because the primary variable costs encountered after averaging normal production are newsprint, ink and other printing supplies, the amount of these inputs used in the production process can be reasonably attributed to advertising and nonadvertising categories since both involve content that is easily separable. The method, however, is weakened because it assumes that readers do not choose to pay to acquire the information contained in advertising, and that advertisers choose only to pay to print their information and have no interest in the nonadvertising information that surrounds it. Despite these limitations, this content-based method is the most usable and valid method for considering costs.

A variation of this second dual-product approach would use content-based apportioning of costs for most expenses, but would also employ direct-time reporting to apportion labor expenses for such functions as composition and engraving. Such reporting of labor time could also be used in analyses of costs associated with submarkets of advertising. Although this would add more precision, it would be only rarely feasible because of the lack of precise and complete measurement and record keeping in most papers.¹⁹

Case-By-Case Refinements

When dealing with specific cases involving predation charges or in trying to avoid risk when setting prices, the analysis discussed above may need to be refined by introducing even more specificity in apportioning variable costs to each specific product. Such refinements would be appropriate if predation charges involve allegations of predatory prices in only some categories of circulation or advertising.

To do so, one could apportion costs by the appropriate submarkets in advertising and circulation. If one were analyzing AVC (circulation), it might thus be appropriate to break the cost down by circulation categories. The refinement might come by splitting costs into subscription circulation costs and single-copy sales costs by applying a percentage representing

TABLE 3: Strengths & Weaknesses of Different Cost Approaches for Newspaper Predation Cases

Approach	Strengths	Weaknesses
Single-product calculations	<ul style="list-style-type: none"> • Calculation ease • Uses readily available data 	<ul style="list-style-type: none"> • Does not separate products • Inability to show predation in advertising or circulation alone
Dual-product calculations <i>Revenue-based allocation</i>	<ul style="list-style-type: none"> • Calculation ease • Uses readily available data • Shows AVC for each product 	<ul style="list-style-type: none"> • Ignores possibility of monopoly leveraging • Can over-allocate costs to a product
Content-based allocation	<ul style="list-style-type: none"> • Calculation ease • Uses readily available data • Shows AVC for each product • Assigns printing costs based on space used per product 	<ul style="list-style-type: none"> • Assumes readers don't pay for advertising • Assumes advertisers purchase only space, not news

their proportion of total sales.²⁰ In some cases it might be necessary to create further subcategories, such as seven-day subscription, weekday subscription, Sunday-only subscription, or newsrack single-copy and dealer single-copy. In determining whether price is below cost, either the wholesale or retail price for that category will be used, depending upon circumstance.

A similar situation could force refinement in advertising costs with their being proportionately assigned by lineage or column inches to categories such as national, retail, classified or preprint. When comparing the appropriately proportioned AVC to price, it is further necessary to refine the ad

rates by using open line, mini-maximal, or actual rate charged to specific advertisers, whichever is most appropriate for the situation.

Because most income and expense statements do not break down the contributions of submarkets to income and expense, one could do so based on percentages of circulation sales submarkets to total circulation or percentages of advertising submarkets to total advertising sales. In some cases it might be appropriate to use production reports or full operating accounting data in making such a determination.

Discussion

Newspaper managers should become more aware of the costs of producing copies of their papers and placing advertising in the papers so that they can make informed pricing decisions and protect themselves against charges of predation. This article has presented workable methods for such analyses that can be undertaken with readily available information and can be inserted into computer programs that generate regular financial statements for newspaper companies.

Simplest is the single-product method. A newspaper manager who uses this method, with an additional computation separating daily and Sunday costs, will find that it produces information that is not only useful in avoiding some potential legal problems but can improve pricing practices and revenue as well. If a manager made such a calculation whenever he or she planned to change any rates, it would provide a significant warning system for potential legal problems.

Although the single-product calculation is the easiest, the best method would choose — and undoubtedly the method that a plaintiff in a predation suit content accounted for by advertising and nonadvertising material. A newspaper manager who conducted only a single-product analysis could thus unknowingly fall below AVC in one of the relevant product markets, thus possibly resulting in litigation involving only that market.

Because of the dual-product nature of newspapers and the effect of circulation sales on advertising sales, some might argue that the single-product basis for determining cost is appropriate. A corollary argument would be that newspaper managers should be allowed to price circulation below AVC to increase circulation and thus the paper's attractiveness to its

advertisers. Such an approach is problematic, however, because courts have recognized the dual-product markets as separate and because it presumes price elasticity of demand for newspaper circulation. Contemporary research in media economics that has shown that demand industry-wide has been inelastic during the past three decades.²¹

Even if one accepts the presumption, one must then accept the notion of a unitary relationship between circulation size and advertising demand. Although there is a relationship between circulation level and advertising sales, a change in circulation will not necessarily or immediately be followed by a change in advertising demand. Demand will be affected more readily by advertising price, industry norms for papers in that circulation size category, the local and national economy and the kind of advertising involved.

Even if the circulation change were very large and resulted in a beneficial change in advertising demand, this could be problematic for the newspaper. In addition to charges of predatory pricing, the paper might well be charged with monopoly leveraging if it used its power in the advertising market to cross-subsidize the circulation in a way that harmed a competing paper's circulation.

Because predation cases often involve only charges of predatory pricing in some submarkets of advertising — such as retail, classified, or national — or in some submarkets of circulation — such as daily home delivery or single-copy sales — it is possible for litigation to occur and the defendant to lose if the price in one submarket is below AVC for that submarket. As a result, case-by-case refinements, such as those described in this article, can be used whenever a newspaper executive wishes to ensure that planned price changes in any market category or submarket do not leave the paper open to litigation.

Newspaper managers should become more aware of the costs of producing copies of their papers and placing advertising if they are to make informed pricing decisions and protect their newspapers from charges of predation by competitors.

Notes

1. See John C. Busterna, "Antitrust in the 1980s: An Analysis of 45 Newspaper Actions," *Newspaper Research Journal*, 9(2):25-36 (Winter 1988).
2. Because of differences between media and advertising products and services provided by daily and weekly newspapers and shoppers, papers do not fully compete in the same markets. Nevertheless, they can bring suit when predation involves a market or submarket in which they both compete. Although it would be possible for broadcast stations and other media to allege predatory pricing by a newspaper, this would be more difficult to maintain because of wide differences in their markets and submarkets. See Robert G. Picard, *Media Economics: Concepts and Issues* (Newbury Park, Ca.: Sage Publications, 1989), esp. Chapter 2.
3. 15 U.S.C.A.
4. See Herbert Hovenkamp, *Economics and Federal Antitrust Law* (St. Paul, Minn.: West Publishing Co., 1985).
5. Robert G. Picard, "Most Papers Use Independent Distributors," *ICMA* (International Circulation Managers Association) *Update*, September 1987, pp. 6-9.
6. Robert G. Picard, "Rate Setting and Competition in Newspaper Advertising," *Newspaper Research Journal*, 3:3-13 (April 1982).
7. See William B. Blankenburg, "Newspaper Ownership and Control of Circulation to Increase Profits," *Journalism Quarterly*, 59:390-398 (1982).
8. An important type of analysis of this type was proposed by Philip Areeda & D. Turner in "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act," 88 *Harvard Law Review* 695 (1975). They argued that short-run marginal costs should be the determining benchmark, with prices lower than that cost being found predatory and prices above being acceptable.
9. The test and a discussion of its rationale are found Sec. 710-722 in Philip Areeda and D. Turner, *Antitrust Law* (St. Paul, Minn.: West Publishing, 1978).
10. In dealing with predation, short-run fixed and variable costs are normally the only issue. If, however, competition is significantly changed requiring a firm to increase long-run productive capacity, long-run costs become an issue. An important discussion of long-run costs is found in Barry Litman, "Macroeconomic Foundations," in Robert G. Picard, James P. Winter, Maxwell E. McCombs and Stephen Lacy, eds., *Press Concentration and Monopoly: New Perspectives on Newspaper Ownership and Operation*. (Norwood, N.J.: Ablex Publishing, 1988), pp. 3-34.
11. W. M. Corden, "The Maximization of Profit by a Newspaper," *Review of Economic Studies*, 20:181-190 (1952-53).
12. See *Standard Chartist of Accounts for Newspapers*, rev. ed. (Moorestown, N.J.: Institute of Newspaper Controllers and Finance Officers, 1979), p. 5.
13. This also assumes that no changes in the quality of editorial or advertising product are occurring that would alter variable cost. Thus, the basic editorial and advertising costs are being held fixed.

14. *Profitability Analysis for Newspapers*. (Institute of Newspaper Controllers and Finance Officers, 1975).

15. See John C. Busterna, "Competitive Effects of Newspaper Chain 'Deep Pockets,'" *Newspaper Research Journal*, 10:4:61-72 (Fall 1988) and "Newspaper JOAs and the Logic of Predation," *Communications and the Law*. (April 1988), pp. 3-17.

16. See *Profitability Analysis for Newspapers*, *op. cit.*, p. 23.

17. For discussions of such subsidies, see W. B. Reddaway, "The Economics of Newspapers," *The Economic Journal*, 73:201-18 (1963).

18. See Herbert Lee Williams, *Newspaper Organization and Management*, 5th ed. (Ames: Iowa State University Press, 1978) and *Profitability Analysis for Newspapers*, *op. cit.*

19. *Profitability Analysis for Newspapers*, *op. cit.*, p. 23.

20. Prorating costs is sometimes difficult because subscription records kept by newspapers often do not adequately break circulation records into categories. This can be done, however, as suggested by William J. Thorn and Mary Pat Pfeil, *Newspaper Circulation: Marketing the News*. (New York: Longman, 1987), p. 153.

21. One can anticipate greater elasticity in competitive newspaper markets than the entire industry, but the presumption of elasticity needs evidence. For discussions of the issues of demand and elasticity in newspapers, see E. Landau and J. Davenport, "Price Anomalies of the Mass Media," *Journalism Quarterly*, 36:292 (1959); Robert Field, "Circulation Price Inelasticity in the Daily Newspaper Industry," M.A. Thesis, University of Oklahoma (1978); J. Clark, "Circulation Increase Despite Higher Subscription Rates," *Editor & Publisher*, Feb. 4, 1976; and Gerald Grotta, "Daily Newspaper Circulation Price Inelastic for 1970-75," *Journalism Quarterly*, 54:379-382 (1977).

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