Cost Analyses of Predation Involving Free Circulation Subsidiaries of Paid Newspapers

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Free circulation papers are among the most rapidly growing segment of the publishing industry and are distributed through home delivery and/or free distribution newstands. The emergence of these papers has spawned competition in some subcategories of the advertising market formerly dominated by daily and weekly paid newspapers.

As competition has increased, charges that some papers are using unfair and illegal practices have also increased. Many of the complaints have resulted in litigation between publishers of free circulation newspapers alleging that their competitors have engaged in predatory pricing in the sale of advertising. Cases have involved complaints of free circulation publishers that daily or weekly paid circulation publishers who operate free circulation subsidiaries do so unfairly and vice versa.

The issues of cost allocation in litigation involving predation by paid daily newspapers, and methods for analyzing costs, have been addressed in scholarly literature (Picard, 1990). Although such analysis provides some bases for analyses of predation involving free publications, the special nature of such litigation, and the fact that it is nearly always pursued in state courts, requires use of cost allocation methods specifically designed for such situations.

Nondaily Free Circulation Publications

Nondaily free circulation publications are called by a variety of names that are often incorrectly used, in an interchangeable fashion, by some observers. The most prevalent terms applied to these publications are shoppers, total market coverage (TMC) papers, and nonduplicating coverage (NDC) papers. The lack of precision in the use of terms is confusing to many when they begin to analyze
the extent to which different publications produced on newsprint compete.

To be correctly called a newspaper, the publication must carry news. Daily publications carrying news and other editorial matter are immediately understood to be included in this category. The definition, however, also encompasses nondaily papers when their contents include substantial amounts of news and editorial matter.

Many nondaily publications produced on newsprint do not carry news and exist primarily for the purpose of conveying advertising. These papers are more correctly called shoppers. The U.S. Post Office does not classify publications for second-class periodical mail privileges if they contain an average of more than 75 percent advertising content (Domestic Mail Manual, Chap. 4). When attempting to precisely label publications, the terms shopper or newspaper are usually applied based on the postal service definition.

In some cases, however, publications devoted primarily to advertising specifically set out to meet the postal regulations by including editorial matter obtained from feature services (Willis, p. 181). Although these publications can qualify for second class mail privileges, they are also normally classified as shoppers because they do not carry news, the primary distinguishing feature of newspapers.

Shoppers and high penetration free nondaily newspapers are attractive to many advertisers because they normally offer better market coverage than daily or nondaily paid newspapers (Willis, p. 181). This higher penetration has made such publications useful to advertisers in markets in which daily newspaper readership is low and reaches fewer than one-third to one-half of the households (Thorn, pp. 4-5).

Total market coverage (TMC) is a term used to designate publications that are distributed to all or a very high percentage of households in a specified market. Such publications can be either newspapers or shoppers. They can be published either as subsidiary operations by daily newspaper publishers or by publishers for whom the TMC publication is the primary product. TMC products have become especially popular among discount chain stores and other retailers that use preprints, that is, advertising that is inserted as a separate ad section into newspapers (Estes III, 1990).

Nonduplicating coverage (NDC) is a term applied primarily to publications produced by daily newspapers for distribution to homes that do not subscribe to the daily newspaper. In some cases, weekly paid circulation newspapers also produce NDC publications. In such arrangements, an advertiser will be guaranteed the same coverage as it would receive from a TMC paper (by publishing its ad in both the paid daily or weekly and the NDC subsidiary). Newspapers that choose to publish NDC rather than TMC subsidiaries generally do so to avoid the additional and unproductive cost of overlapping coverage.

TMC and NDC publications are recognized as means for paid newspapers to gain additional revenue from a subsidiary operation, but also as a means to halt or slow development of non-daily free newspapers or shoppers as competitors for some categories of advertising. Lavine and Wackman, for example, note the importance of such subsidiaries as defenses with "the goal of protecting the newspaper's franchise" against shopper and direct mail competitors (Lavine and Wackman, pp. 66-67). The same tactic is also employed by some weekly newspaper publishers.

When speaking of TMC or NDC newspapers or shoppers and related publications in a generic sense, the most precise term that can be applied without misapplying terms is free circulation publications or papers.

Market Definitions

The questions, whether, and the extent to which, paid and free circulation publications exist in the same product market have been widely debated. The issue is crucial, however, in predation lawsuits because the publications must be shown to exist in the same market for unfair competition to occur. Two legal decisions are relevant in making the determinations when one considers the newspaper industry.

In U.S. v. E.I. du Pont de Nemours & Co. (1956), the Supreme Court set out two key elements to determine product markets. Products that are reasonably interchangeable, that is, can be used for the same purpose and are of similar appearance, and are products for which price changes lead to cross-elasticity of demand, are considered to be in the same product market.

The second case, Brown Shoe Co. v. U.S. (1962), laid out criteria to determine whether products compete in the submarkets. The decision indicated that seven major criteria can be employed in making such determinations: 1) industry or public recognition of the submarket as a separate economic industry; 2) products with peculiar characteristics; 3) products requiring unique production facilities; 4) products with distinct products; 5) products with distinct prices; 6) products sensitive to price changes; and 7) products with specialized vendors.

In predation litigation of the type discussed here, the market issue generally involves only one of the dual products of paid publications, that is, advertising (Picard, 1989). Assuming that the competing publications exist in and serve the same or a reasonable portion of the same geographic market, the issue is whether they exist in the same advertising product market. This is compounded by the fact that newspapers and shoppers compete in four advertising submarkets: local (retail), classified, preprint/insert, and national. Both the publications and the advertisers approach the four major advertising submarkets differently.
The markets in which publications compete and the degree to which they compete differ. Daily newspapers are typically the only publications to participate in all four markets. Weekly newspapers compete mostly in the local advertising market and shoppers depend most on the local advertising and preprint markets (Table 1).

<table>
<thead>
<tr>
<th></th>
<th>Local Ads</th>
<th>Classified Ads</th>
<th>Preprints/Inserts</th>
<th>National Ads</th>
</tr>
</thead>
<tbody>
<tr>
<td>Daily Newspaper</td>
<td>Primary</td>
<td>Primary</td>
<td>Secondary</td>
<td>Primary</td>
</tr>
<tr>
<td>Weekly Newspaper</td>
<td>Primary</td>
<td>Secondary*</td>
<td>Secondary</td>
<td>Doesn't Compete</td>
</tr>
<tr>
<td>Shopper (TMC/NDC)</td>
<td>Primary</td>
<td>Secondary</td>
<td>Primary</td>
<td>Doesn't Compete</td>
</tr>
</tbody>
</table>

*As noted in the article, this category can be primary in some suburban and rural weeklies.

The three types of publications serve the needs of advertisers differently in each market. In markets in which a daily newspaper exists, it generally is the primary choice for local retail advertising. If a weekly newspaper or shopper exists, these advertisers may supplement the daily newspaper's services with advertising in these other publications. Retailers would rarely substitute the weekly or shopper as their main outlet for advertising, unless the daily's rates were unusually high or the secondary publications served a specialized audience better suited to the advertiser than the general newspaper reader.

Advertisers use classified advertising differently as well. Daily papers gain the high volume classified advertisers, such as major employers, real estate firms, and auto dealers. This gives them a base that generally makes them more attractive to individuals and other businesses that use classified advertising less often. Weeklies and shoppers tend to serve only this second class of advertiser (unless no local daily exists), advertisers who wish to supplement their classified ads in daily newspapers, or advertisers who use secondary papers to reach only an audience with characteristics different from that of paid daily publications. In some suburban and rural weeklies, however, advertisements for home and agricultural supplies, real estate, used merchandise, and other products and services make classified advertising a primary rather than secondary market.

The preprint market results in significant competition because shoppers or paid publications can both serve their purposes. Major preprint advertisers tend to move to shoppers, as noted above, when penetration levels of the paid publications are low or advertising rates in those publications are no longer cost effective.

In litigation between a paid and free circulation publication, specific determinations must be made of whether a subsidiary shopper is a similar or different product from the paid publication, which advertising submarkets are being contested, how large the submarkets are, the degree to which each publication competes in those market, how the publications serve advertisers in the specific submarket, and the sensitivity of submarkets to price.

When a TMC or NDC publication is produced by a paid newspaper it is a subsidiary product, rather than an extension of the same product. Newspaper firms, like other firms, can produce multiple products in the same facility without their being considered the same product. Although free circulation publications use byproducts and some facilities of daily newspapers, they are no more a part of the daily product than lesser cuts of tuna and tuna byproducts packed for cat food are the same product as tuna sold for human consumption by a fish canary.

The financial relationship between audiences of the paid and free circulation papers and the products are also so different that it is nearly impossible to argue that audiences attach the same import to both products.

Distribution of the papers is usually handled separately from the daily newspaper, which operates a much more complex system involving home delivery and single copy sales (Thorn, p. 6). Individuals who handle distribution of free circulation papers are paid separately from payments for delivery of the paid publications, and are not independent retailers of the product as they usually are in the case of paid newspapers.

Free circulation papers thus have format differences, content difference, price differences, and distribution differences that distinguish them from paid publications.

It is also difficult to consider these subsidiaries as being in the same market because they seek substantially different audiences. In the case of most free circulation papers, the audience is often double that of the paid daily. In the case of NDC papers, the market excludes the daily's consumers. Indeed, the primary purpose of free publications is to serve a different audience, that is, market, than
paid publications.

It would be difficult to maintain that a free and a paid circulation paper should be classified as the same overall product, but clearly, paid and free publications have the ability to compete in some submarkets, even if they do not significantly compete across all submarkets. Given the criteria in du Pont de Nemours and Brown Shoe, as well as the realities of the newspaper industry, paid and free publications have the ability to be considered competitors in some submarkets of advertising in some geographic markets, but must be considered separate products overall.

**Allocation of Costs**

In predation litigation, once the market issues are settled, the question of unfair competition involves the issue of whether a competitor is selling his product below cost in order to harm another competitor. In order to determine cost, analysis of the financial records of the firm charged with illegal behavior are made.

The Financial Accounting Standards Board has created no specific newspaper industry accounting standards; thus accountants, auditors, and analysts follow the board's general standards (Financial Accounting Standards Board, 1989) supplemented by materials and interpretations available from the International Newspaper Financial Executives. That group's material and reporting guidelines offer minimal advice and broad categories for reporting revenues and expenses.

The Standard Chart of Accounts for Newspapers, established by the Institute of Newspaper Controllers and Finance Officers (now International Newspaper Financial Executives), does not include accounts for specific expenditures for TMC, NDC, or other free circulation products of paid newspapers. Without directly doing so, however, the group provides the framework for them to be added through extended accounts that can be used if the firm publishes a morning and evening paper and incurs direct costs that could be allocated to each (Standard Chart of Accounts for Newspapers, 1979).

In order to create full accounting of free publications, a paper would have to establish special expense accounts to cover such expenditures and require all departments to keep records of all direct expenses for the subsidiary.

Such full, direct reporting would be preferable to most accountants because it would provide more information with which to analyze a publisher's operations, and it would clearly be preferred in doing cost allocation in predation cases. Publishers of free papers, however, rarely do more than create a broad account to cover clearly attributable direct variable costs; thus the most preferable cost allocation method is not available.

The limitations imposed by the lack of direct reporting of all expenses associated with these subsidiary publications does not make it impossible to analyze costs, but rather forces use of inferior means of allocating costs and extrapolating data and formulae from the firm's activities in a reasonable manner consistent with guidelines of the jurisdiction in which litigation is undertaken.

Newspapers typically keep records that permit extrapolation of costs, although these are rarely fully reported on balance sheets. Such data includes revenue and lineage data for retail advertising, classified advertising, preprint and insert advertising, and other categories of advertising. Production records usually record gross pages printed, as well as information of supplies used.

The newspaper finance group has addressed cost allocations and has suggested bases for allocating 12 categories of costs between two daily newspapers published by the same firm (Profitability Analysis for Newspapers, pp. 16-24). The model includes some elements useful in allocating costs between a daily or weekly and a free circulation subsidiary through its allocation of full newspaper costs between the two papers, usually a morning and evening publication. These guidelines will be applied and discussed later in this paper.

When dealing with predation, federal and some state courts have adopted the Areeda-Turner Test to indicate below cost pricing. The test relies on calculations of average variable cost (AVC) and accepts the view that prices below AVC are predatory if other evidence shows intent to harm and demonstrable harm to competition (Areeda and Turner, 1975 and 1978). This test, then, requires a determination of what is included in variable cost in order to establish the AVC for the product.

Some states, however, do not accept the Areeda-Turner approach and require full cost allocation for the determination of whether the product was sold below cost. Some others take a rule-of-reason approach. This presents the problem of determining how overhead costs shall be allocated between a paid paper and its free circulation subsidiary.

Thus, three major methods of allocating costs exist for use in predation analysis of free circulation subsidiaries of a paid publication: 1) incremental cost allocation; 2) full cost allocation; and 3) proportional cost allocation.

In explaining these allocative analyses, this paper will use the example of a paid daily newspaper's accounts, but the techniques are similar if a paid weekly were the defendant. The number of accounts and accounting techniques used by weeklies are typically simpler, but the approaches used would be similar.

**Incremental cost allocation** This type of allocation includes only the direct variable costs of operating a subsidiary product. In the case of free circulation publications, it means that newspaper, ink, plates, and distribution costs beyond those of the paid publication would be included in the analysis.

Paid newspapers prefer this type of analysis when predation suits are brought against them because it requires no significant cost calculation, uses readily available accounting data, and tends to favor the defense.
In carrying out this type of analysis, one calculates variable costs for producing the free product. This means separating the costs of newsprint, ink, and plates, etc. for the subsidiary product and comparing them with the advertising income from that publication. This separation is a normal newspaper recordkeeping and accounting function and the results are typically included on the income and expense statements of paid newspapers operating such publications (see sample income and expense statement).

**SAMPLE INCOME AND EXPENSE STATEMENT FOR A DAILY NEWSPAPER WITH A TMC SUBSIDIARY**

<table>
<thead>
<tr>
<th>Revenues</th>
<th>% of Subtotal</th>
<th>% of Total Adv. &amp; Circ.</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local                     $ 8,450,132</td>
<td>51.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>National                  $ 1,975,001</td>
<td>12.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Classified                $ 4,224,500</td>
<td>25.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TMC                       $ 1,257,622</td>
<td>7.7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Preprint                  $ 542,677</td>
<td>3.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Subtotal</strong>              $16,449,932</td>
<td>79.6</td>
<td>76.0</td>
<td></td>
</tr>
<tr>
<td>Circulation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Subscription              $ 3,459,862</td>
<td>20.4</td>
<td>19.5</td>
<td></td>
</tr>
<tr>
<td>Single Copy               $ 754,132</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Subtotal</strong>              $ 4,213,994</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Adv. + Circ. Revenue</strong> $ 20,668,139</td>
<td>95.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Revenue             $ 965,668</td>
<td>4.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Revenue</strong>         $21,633,807</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Summer 1991**

<table>
<thead>
<tr>
<th>Expenses</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production                 $ 2,321,111</td>
<td>14.0</td>
</tr>
<tr>
<td>Newsprint                 $ 4,532,784</td>
<td>27.3</td>
</tr>
<tr>
<td>Ink                       $ 578,931</td>
<td>3.5</td>
</tr>
<tr>
<td>Plates, etc.               $ 187,456</td>
<td>1.1</td>
</tr>
<tr>
<td>TMC                       $ 1,057,455</td>
<td>6.4</td>
</tr>
<tr>
<td>Advertising               $ 1,255,334</td>
<td>7.6</td>
</tr>
<tr>
<td>Circulation               $ 1,954,779</td>
<td>11.8</td>
</tr>
<tr>
<td>Editorial                 $ 1,734,598</td>
<td>10.5</td>
</tr>
<tr>
<td>Administration            $ 1,378,422</td>
<td>8.3</td>
</tr>
<tr>
<td>Promotion                 $ 479,002</td>
<td>2.9</td>
</tr>
<tr>
<td>Building and Land         $ 769,554</td>
<td>4.6</td>
</tr>
<tr>
<td>Equipment                 $ 344,798</td>
<td>2.1</td>
</tr>
<tr>
<td><strong>Total Expenses</strong>        $16,594,224</td>
<td></td>
</tr>
</tbody>
</table>

**Net Income Before Taxes + Adjustments** $ 5,039,583

| Gross Pages Printed (Daily) | 373,760,000 |
| Gross Pages Printed (TMC)  | 54,912,000  |
| **Total Gross Pages Printed** | 428,672,000 |

| TMC Ad Revenues            | $ 1,257,622  |
| Retail                     $ 597,425     | 47.5        |
| Classified                 $ 281,542     | 22.4        |
| Insert/Preprint            $ 378,655     | 30.1        |

Using the example from the table, the TMC publication contributed $1,057,455 to expenses, while receiving $1,257,622 in revenue. On the face of this incremental cost analysis, it would appear that no below-cost sales are occurring, but the analysis should be taken further to account for the specific
advertising market in which predation is alleged. This would mean using
revenue figures for that submarket and prorating them to incremental expense
based on their percentage of revenue or lineage.

Thus, if prices for carrying preprint advertising were being disputed, the
total TMC expenses of $1,057,455 would be multiplied by the percentage of
revenue for which preprints account (30%), yielding a figure of $318,294. This
figure is lower than TMC ad revenues received for preprints, leading to the
conclusion that no predation is occurring in that advertising submarket. This
result would be expected as long as total revenue exceeds total expense, as is the
case of the sample TMC operation. If losses were shown for the TMC operation,
however, the process would be useful in yielding indications of below-cost
pricing in a submarket of advertising. The use of preprint expense and income
in this fashion, however, assumes that the paid publication would continue
publishing the subsidiary with or without preprints and that only the preprint
portion of the expenses is relevant. Because a primary purpose for such
publications is preprints, the assumption is problematic.

This type of analysis also hides creation, production, and distribution costs
of the free product by allowing papers to utilize the additional equipment,
facility, and personnel capacity of their paid publications for their unpaid
products without accounting for its use. The result is that the approach does not
account for: many advertising and editorial department labor, supply, and
selling costs; many composing and pressroom labor and supplies costs; additional
wear and tear on equipment; full distribution costs; and business and admin-
istrative costs.

Incremental cost analysis thus gives an unrealistic picture of costs and
provides artificial cost advantages that publishers of free circulation subsidi-
aries can use to obscure their real costs if unfair practices result in litigation against
competitors who must bear and account for all their costs.

Full cost allocation In some states, the question of what type of cost allocation
use in predation litigation has been settled by state antitrust law. The
California Unfair Practice Act (California Business and Professions Code), for
example, stipulates that full cost allocation shall be used in charges involving
predation. Its approach has been followed by a number of states. The act makes
it clear that everything from materials and labor, from depreciation to admin-
istrative costs, from interest payments to bad debts, and from maintenance
costs to taxes shall be included in cost analyses.

In such situations, cost allocation is typically made by dividing the entire
costs of the firm across the total amount of product produced, thus creating an
average unit cost. In the case of newspapers, this can be accomplished by
determining the total number of pages printed in both the daily and subsidiary
publication.

Thus, if the paper whose budget is illustrated in the sample income and
expense statement printed 373,760,000 pages annually for its daily paper and
54,912,000 pages annually for its free circulation subsidiary, it would produce
a total of 428,672,000 pages during the year. The total expense of $16,594,224 is
then divided by the 428.7 million pages to yield a cost of 3.9 cents per page. One
can then multiply the per page figure (3.9 cents) by the free publication's pages
(54,912,000) to yield an expense allocation of $2,141,568 for the subsidiary
publication.

Having thus allocated costs, one can compare this free circulation paper's
expense measure to its income to determine whether sales are below cost. In the
case of the illustration, income of $1,257,622 is 40 percent below the free
publications' allocated expense, thus indicating significant below-cost pricing.
The calculation, however, does not provide an indication of in which
category(ies) of advertising below-cost sales have occurred. Additional computa-
tions are required to make that determination.

To determine where below-cost sales are occurring, one divides the free
paper’s allocated expense by the percentage of income from the various types of
advertising it carries. Thus, if retail ads accounted for 35 percent of income,
prices of retail advertising would be below cost if the income from such sales did
not exceed $749,549. In order to make such a figure more applicable to specific
sales situations it would be appropriate to create a per inch or per standard
advertising unit figure by dividing the retail advertising expense by total
number of retail advertising inches or total number of standard advertising
units of retail advertising.

This same type of calculation would be appropriate for insert advertising
carried in free circulation vehicles, even though they are not usually printed at
the firm. The reason for including them in this type of calculation is that unpaid
publications are often created by paid publications primarily to attract or keep
such inserts ads; the subsidiary generally would not be published without them.
Thus, costs for the entire subsidiary publication should be prorated by preprint
ad income when considering that market.

It could be argued that the determination of what percentage of free
publication costs should be allocated to each category of advertising should be
made on the basis of the percentage of page space taken up by the advertising
categories in the free publication. This cannot be reasonably done, however,
without wholly minimizing the impact of any inserts published.

Even in full-cost allocation, some overhead costs might be reasonably
excluded. To do so, however, generally requires a clear and reasonable justifi-
cation. In the sample income and expense statement, for example, the paper
shows “Other Revenue” of nearly $1 million. This could be the result of job
printing and the parallel expenses would be appropriately removed before
attempting the above calculations to determine predatory pricing in the free
circulation publication.

Despite its required use in much litigation, the full cost allocation method is problematic because it overestimates the expense contributions of free publications. Only in the rarest circumstances do such publications result in increases in fixed costs. Such publications rarely result in significant increases in costs for equipment, buildings and land, promotion, general personnel, and other items. The fact that they do not require significant investments in such items is a primary reason that the prospect for starting and operating an unpaid subsidiary publication is so attractive to publishers of paid papers.

Proportional Cost Allocation This type of analysis attempts to overcome the weaknesses of incremental allocation by allocating true costs for the subsidiary publication. It also attempts to ameliorate the weaknesses of full cost allocation that over-allocate costs to the free paper. Its use can be requested in jurisdictions in which full-cost allocation is not required.

Proportional cost allocation uses incremental costs but combines them with a calculation of the portion of the total business for which the free product accounts and applies those calculations to overhead expense items that can reasonably be expected to increase because of the operation of the subsidiary.

Proportional cost allocation is based on the view that most subsidiary publications are operated without significantly increasing editorial, administrative, promotion, building and land, or equipment expenses. Most papers reuse some editorial and advertising materials created by employees of the daily paper in the subsidiary and assign accounting, production, and related tasks to existing employees. It is rare for new employees to be hired specifically to handle the addition of a free publication.

Nevertheless, proportional cost allocation recognizes the fact that some advertising designs and layouts are created specifically for the subsidiary and that some are reused from the daily. It recognizes that commissions are paid for free publication advertising sales. It recognizes that business employees must keep accounts for and bill subsidiary product customers. It recognizes that when editorial matter is included, it must be prepared and edited. It accounts for the fact that personnel are used to insert preprints and other material in the free publication and that costs are incurred in distributing it to homes and/or newsstands. Some accounting for such costs must be made if cost allocation is to be reasonable and equitable.

Thus, proportional cost allocation seeks to determine that portion of the costs of the production, advertising, circulation, and administrative departments reasonably attributable to the subsidiary, as well as calculating the additional costs of newsprint, ink, and plates.

In cases in which a newspaper's record keeping provides a direct accounting of employee hours and supplies used for the paid and free circulation products, this process is facilitated by easy access to data. With the exception of newsprint, ink, plates, and some production labor, however, most newspapers do not typically account directly for such expenses.

As mentioned earlier, the International Newspaper Financial Executives group recognized the need to allocate costs between two papers published by the same firm to provide clearer accounting for costs and better managerial decision making. When record keeping does not permit clear allocation, the group advocates use of a number of proportional analyses based on calculations using labor hours, percentage of content, newsprint usage, number of papers published, and pages printed to extrapolate the percentage of all costs that should be allocated to each paper. This approach is germane to the issue of allocating costs to a free circulation subsidiary, but must be modified to recognize that such subsidiaries do not participate in the advertising content market in which content is sold to consumers. The entire costs must then be judged using only the subsidiary's participation in the advertising market. (In many ways this is much simpler than the problem presented in allocating costs when the dual products of paid newspapers are involved, as described in Picard, 1990.)

To overcome this difficulty, it is appropriate to allocate whatever direct free publication expenses can be accounted for and to prorate expenses in other categories based on percentage of advertising revenue of the subsidiary. Thus, in the case of the example in Table 1, costs appropriately included in partial cost allocation are the direct expenses reported for the TMC (this normally includes the variable costs of newsprint, ink, plates, etc.) plus the percentage of advertising revenue for the TMC multiplied by expenses for advertising, administration, production, and circulation departments for which direct accounting is unavailable. (Some observers might consider using advertising lineage published, rather than income received, in this proportional cost analysis. Use of lineage is problematic, however, because it does not adequately account for the effect of preprints on the decision of the management of a paid paper to launch and maintain a free circulation publication.)

This means adding the incremental costs of $1,057,455 for the TMC subsidiary to 7.7 percent of the advertising, administration, production, and circulation costs [$1,255,334 + $1,378,422 + $2,321,111 + $1,954,779 (circulation) = $6,909,656 x 7.7%]. This calculation yields an expense of $1,589,499. Given TMC income of only $1,257,622, below-cost sales appear evident.

If preprints were included in the retail advertising submarket only, the $1,589,499 would be multiplied by the percent of total TMC revenue from that submarket (47.5) to yield a retail advertising expense calculation of $755,012.03. Given that retail advertising contributed only $597,425, below-cost sales continue to be evident.

Although this method yields purer results than the preceding two alloca-
tion methods, it still over-allocates some costs, unless those are permitted to be removed. A prime example of this occurs in the area of circulation costs. Unless the daily newspaper's circulation department is fully involved in the distribution of the TMC product, a rarity, much of the costs more correctly attributed to the daily are shifted without a reasonable basis except consistency. Similarly, editorial costs, building and land, and equipment costs are over-allocated to the TMC by using the proportional costs, but to a far smaller degree than in full cost allocation.

Refinements

Obviously, the types of analyses outlined above must be refined to use the financial data available for analysis of a specific situation. The general outlines of the three types of analysis can be applied in a variety of situations, however, and allow for the use of different levels of specificity in a newspaper's accounting system.

In some cases, it might be appropriate to seek even greater precision than that offered by the proportional cost allocation method. If financial data were available, one could accomplish the goal of reducing the over-allocation problem by considering a ten-year trend of costs in administration, production, advertising, and circulation prior to establishment of its free circulation subsidiary. This trend could then be adjusted for inflation and increases in circulation or advertising lineage and applied in creating proportional analysis after the establishment of the subsidiary product.

Summary

This article has presented three methods of cost allocation that can be utilized when the Areeda-Turner Test using average variable costs is not appropriate or accepted. Table 2 summarizes the strengths and weaknesses of each approach. The author believes that proportional allocation presents the most reasonable method for cost analysis in that it balances the interests of both plaintiffs and defendants and reduces the under- and over-allocation problems associated with the incremental and full cost analysis methods.

A number of refinements are also possible under the proportional system, depending upon the records kept by the newspaper defendant. If the records include the weight of newspaper products distributed, for example, it might be more appropriate to use such figures in the proportional calculation of distribution costs.

Because many predation lawsuits occur early in competition between free circulation papers, another issue arises: whether losses associated with a free publication subsidiary are necessarily evidence of predation. Indeed, reasonable losses associated with a free publication might need to be considered as an investment cost in a new product that would reasonably be expected to be recovered over time. This, of course, begs the question of the intent of the party involved.

<table>
<thead>
<tr>
<th>Approach</th>
<th>Strengths</th>
<th>Weaknesses</th>
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<tbody>
<tr>
<td>Incremental</td>
<td>• Ease of calculation</td>
<td>• Under-allocates many real costs</td>
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<td></td>
<td>• Uses readily available data</td>
<td>• Favors defendants</td>
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<tr>
<td>Full</td>
<td>• Ease of calculation</td>
<td>• Over-allocates costs to TMC/NDC products</td>
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<td>• Uses readily available data</td>
<td>• Favors plaintiffs</td>
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<tr>
<td>Proportional</td>
<td>• Uses readily available data</td>
<td>• Over-allocates some costs to TMC/NDC products</td>
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<td>• More balanced treatment of interests of plaintiffs and defendants</td>
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</table>

References


Brown Shoe Co. v. U.S. (370 YS 294 (1962)).

California Business and Professions Code §17026 and 17029.


U.S. v. E. I. du Pont de Nemours & Co. (351 US 377 (1956)).