

**Milk Market Channel Structure: Its Impact on Farmers  
and Consumers, and the Inadequacies of Antitrust  
Enforcement as a Foundation for Dairy Policies:  
Evidence from the Northeast Dairy Industry**

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**Testimony**

**Monopsony Issues in Agriculture:  
Buying Power of Processors in Our Nation's Agricultural Markets**

**Judiciary Committee, United States Senate**

**by**

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## Executive Summary

- The drive for deregulation in milk markets has been predicated on competitive market assumptions. Ignoring substantial market power of processors and retailers distorts the policy process.
- Dairy farmers in the northeast, and possibly other high fluid utilization areas, are suffering low fluid raw milk prices because of a pincer movement in policy. Federal Market Orders have been relaxed to allow competitive market forces to set fluid milk prices, but antitrust enforcement has been inadequate. Consequently, private economic power has replaced competitive market forces in the pricing process. Farmers' prices are lower, and consumer prices are higher than they would be in a competitive market channel. This results in allocative inefficiency as well as skewed income distribution.
- Seller concentration in the retail grocery industry in southern New England has increased significantly. The partial HHI (top four firms) for the three large Information Resources Inc. (IRI) market areas that cover nearly all of Massachusetts, Rhode Island and Connecticut are as follows: Boston 1765 in 2003, up from 1326 in 1996; Providence 3120 in 2003, up from 2591 in 1986; and Hartford 2695 in 2003, up from 2021 in 1996. In smaller relevant geographic markets for antitrust analysis market concentration is even higher and in most cases well above the 1800 HHI threshold in the Federal Merger Guidelines. Serious questions about the exercise of market power in these markets exist.
- Stop and Shop has consolidated a dominant firm market position in markets through southern New England. Its aggregate market share is 51.5 percent in Rhode Island and 49.5 percent in the Hartford IRI area (CT and western Massachusetts). It is 32.8 percent in Boston IRI (eastern Massachusetts without Cape Cod). Again, these market shares are higher in smaller relevant geographic markets for antitrust analysis.
- Merger enforcement in the New England supermarket industry has been very active; however, in retrospect it has been inadequate. The large divestiture of 31 stores with over \$600 million in sales from the Royal Ahold/Edwards acquisition of Stop and Shop in 1996 did not constrain Stop and Shop's move to dominance in many local markets.
- With its rise to dominance, Stop and Shop has become the price leader in the retail milk market. Pricing evidence for the Hartford and Providence IRI market areas corroborate this shift.
- The Dean Foods milk processing company or its predecessor, Suiza Dairy, acquired and shut down several milk processing plants in New England since entering the area in 1997. In 2000 Dean processed over 63 percent of the region's milk. Hood was a distant number 2 with 20 percent of the market. Dean is a dominant firm.
- Dean and Stop and Shop have a 15-year strategic alliance for the supply and marketing of fluid milk. Dean processes and distributes milk to Stop and Shop stores for 52.5 cents per gallon over raw milk costs. Other supermarket chains pay Dean substantially more,

61.5 cents per gallon over raw milk costs. Although this price difference is most likely not cost justified, other chains have no Robinson-Patman claim against the alliance because Stop and Shop does not use the wholesale price advantage to compete on price and thereby damage other chains. It has elevated prices and widened profit margins.

- Concentration has also increased dramatically at the milk assembly stage of the northeast milk-marketing channel. Dairy Farmers of America, the nation's largest milk marketing cooperative, has formed Dairy Marketing Services, a marketing agency in common with several other cooperatives including DairyLea, and Land O Lakes (northeast division). DFA and DMS have full supply contracts with Dean Foods and National Dairy Holdings, the nation's two leading processors who are dominant in the northeast.
- St. Albans Cooperative has joined DMS to preserve its long-standing supply relationship with Stop and Shop, who closed its milk plant in 2000 and now receives milk from Dean.
- The proposed NDH Hood merger could shift Hood's supply from Agrimark to DMS. If that happens, Agrimark faces possible exclusion from the federal market order fluid milk pool. To avoid this, Agrimark might also join DMS giving them a virtual monopoly on milk assembly in New England.
- DMS seeks to benefit farmers by rationalizing milk assembly and lowering hauling costs. This is a real benefit but not enough to substantially improve farmer welfare.
- Even as a monopoly DMS cannot exert substantive market power against downstream processors and retailers to elevate farm milk prices. If DMS attempted this, Dean and NDH could use traditional pool-busting payments to independent farmers that have defeated cooperatives bargaining in the region in the past.
- Surveys of retail milk prices in November 2002 and June 2003 indicate that retail milk prices in the metro New York and Hudson River area are 59-70 cents per gallon lower than in southern New England. New York's price gouging law is the primary cause of this difference.
- Information on processing and delivery costs from Dairy Technomics allows the decomposition of retail prices for brands and supermarket chains. For milk aggregated across all brands and the top four chains in southern New England we report the following for June 2003. Farmers received \$1.03 per gallon for the raw milk bottled. Processors collected an additional 59.6 cents per gallon for processing and transporting the milk to supermarkets, i.e., the delivered wholesale price averaged \$1.63 per gallon. Finally, retailers charged \$3.07 per gallon so their gross margin was \$1.45 per gallon.
- Research at the University of Maine and Pennsylvania State University indicate that in-store milk handling costs range from 20 to 40 cents per gallon. Thus the leading supermarket chains net profit margins for milk are effectively equal to or more than what the farmer receives for producing the milk. This is allocatively inefficient and unfair pricing.

- On a per hundredweight basis, an excess profit of a dollar per gallon translates to \$11.60 per hundred pounds of milk (cwt). Research at Iowa State suggests that milk market offers elevate fluid milk prices approximately \$1.50 per cwt. The exercise of private market power outweighs publicly sanctioned price enhancement by a ratio of 7 to 1 or higher.
- Current retail milk pricing practices by retailers capture nearly all of the brand premium that processors create when they differentiate their milk. The innovators are not reaping the benefits of their success.
- The excessive retail margin not only damages consumers via higher retail prices, it also damages farmers via low over-order fluid milk premiums.
- An analysis of farm level milk prices in the upper Midwest and the northeast indicates that northeast consumers will pay higher prices if the region becomes milk deficient and hauls in products from the Midwest.
- Policy options include:
  - More vigorous antitrust enforcement, especially against the NDH-Hood merger.
  - A strengthening of the Federal Milk Market Orders by elevating the Class 1 differential in monopsonistic markets to protect farmers from low prices.
  - State level initiatives to link farm prices to wholesale and retail prices. This option uses a price collar approach that can lower consumer prices and elevate farm prices without imposing price ceilings or price controls. Price collars change the incentive structure in the market channel. Profit maximizing behavior leads to prices that eliminate most of the excessive channel profit margin; however, firms still earn profits.

# **Milk Market Channel Structure: Its Impact on Farmers and Consumers, and the Inadequacies of Antitrust Enforcement as a Foundation for Dairy Policies: Evidence from the Northeast Dairy Industry**

## **I. Introduction**

The U.S. dairy industry involves more than consumers and dairy farmers. Dairy cooperatives assemble and market their member's milk. The nation's dominant dairy cooperative, Dairy Farmers of America, has a strategic alliance with other cooperatives, Dairy Market Services, which in turn has a full supply contract with the nation's two largest fluid milk processors, Dean Foods, and National Dairy Holdings. Fluid processors and the retail distribution system, most notably large supermarket chains, have recently become extremely powerful players in milk market channels. This is well known to anyone who follows issues in the industry, however, virtually all of the economic analysis of federal and state dairy policies assumes that dairy market channels are competitive.<sup>1</sup>

Moreover, or perhaps as a consequence of the constrained analytical approach, resulting dairy policies are almost exclusively based upon competitive channel assumptions. Alternatively dairy policy makers have ignored the implications of departures from competition on policy construction and policy impacts. As this testimony will demonstrate this omission has had a particularly damaging impact on the Northeast and especially New England.

In the political arena the competitive channel assumption provides cover for milk channel firms who recommend the virtues of competition to farmers. By assumption, channel firms are competitive so their conduct escapes scrutiny and the debate focuses on dairy policies as distortions in an otherwise competitive industry. This is a most inaccurate and unfortunate framing of dairy pricing problems.

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<sup>1</sup> See for example Jesse et al (2002) and Balagtas and Sumner (2003).

The importance of antitrust enforcement in the fluid marketing channels should now be clear. If vigorous and effectively competitive conditions prevail then these “Chicago School” competitive market models of agricultural production and food marketing channels have more standing.<sup>2</sup> However, we submit that in several areas of the country, dairy farmers have been the victim of a pincer movement in policy. Dairy policies have been relaxed to allow market forces to determine farm level milk prices. For example, when discussing federal fluid milk market orders, Jesse et al. state that fluid milk market orders should,

“Allow competitive forces to determine effective prices. Administered federal order prices are designated as minimum prices. If the cost of supplying fluid milk relative to supplying manufacturing markets is greater than the Class I differential, then cooperatives can and do obtain premiums to cover the difference and raise the effective Class I price to a competitive level” (Jesse et al, 2002, p. 23)

At the same time antitrust enforcement has failed to challenge successfully horizontal mergers and vertical strategic alliances in many regional milk marketing channels including New England. Consequently, we now have very few, large, and interconnected firms in many regional and local dairy market channels. In regions where this is the case and the federal order minimum prices for fluid milk have been lowered to make room for competition, competition can be subverted by powerful buyers that leave fluid milk prices below competitive levels.

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<sup>2</sup> Over the past 70 years economists have offered other cogent rebuttals, alternative models of industrial organization if you like, to this textbook competitive market characterization of agricultural production and food marketing channels. Agricultural commodity and market regulatory policies are needed, and in many instances efficiency enhancing because:

- Agricultural production is an uncertain biological process subject to the vagaries of disease and weather.
- There is an over production trap in farming due to high fixed costs and decentralized production units.
- Rapid technical progress produces a treadmill effect. Farmers that are slow to adopt technology lose.
- Production is seasonal, subject to longer run cycles and price instability.
- The product is fresh, and you must sell it or smell it so farmers are susceptible to “hold ups” in the market place.
- Food safety is a concern.

The promoters of increased concentration in processing and retailing have claimed that economies of size bring cost efficiencies that result in lower consumer prices. Empirical evidence paints a stark and different picture. In New England, the Pacific Northwest and elsewhere, supermarket fluid milk prices are extremely high when compared to raw fluid prices and processing and retailing costs (Rabinowitz et al. 2003, Cotterill et al. 2003, Robinson 2003).

In this paper we will illustrate how the dairy policy and fluid milk pricing problem has changed in the New England fluid milk channel since the mid 1990's. We will do so by explaining how the structure of the New England fluid milk channel has changed, how fluid milk policies have changed, the interaction between policy and channel structure, and the impacts on farmers, channel firms, and consumers. A central theme to this narrative is the interplay of public and private market power with their impacts on raw fluid and retail fluid milk prices.

We will demonstrate that milk pricing has changed and channel firm net profit margins have widened as channel concentration has increased. The case study also strongly suggests that market power is being exercised against farmers in the Northeast via low over-order premiums as well as against consumers in Southern New England via higher retail prices.<sup>3</sup>

## **II. The Inadequacy of Antitrust Enforcement: Rising Concentration and Vertical Strategic Alliances in the New England Milk Marketing Channel**

Since 1996, several major structural events occurred in the New England supermarket and fluid milk processing industry. In this section we will document changes in market structure at the supermarket, processing, and milk assembly stages of the fluid milk channel. We also will

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<sup>3</sup> The current situation is virtually identical in the Pacific Northwest. See Rabinowitz et al. for analysis. Chicago has also experienced noncompetitive fluid milk pricing. Minneapolis has high retail prices relative to costs, as do many other areas, that merit investigation (USDA, 2003a)

review salient antitrust actions, explain how antitrust enforcement was inadequate, and offer some observations on current antitrust issues.

## **II.1 The Increase in Concentration in Supermarket Retailing in New England**

The watershed merger for the diminution of supermarket competition in Southern New England is the Royal Ahold acquisition of Stop and Shop in 1996. Stop and Shop was, and is today, the leading supermarket chain in Southern New England. Royal Ahold/Edwards supermarkets was the number two chain in many local markets in Southern New England. The Federal Trade Commission (FTC) and the Massachusetts, Connecticut, and Rhode Island Attorney Generals adopted a fix it strategy and negotiated a major divestiture of 31 supermarkets with sales of over \$600 million to smaller competitors in an attempt to preserve competition.

As an economic expert for the states, the lead author of this testimony provided the market area analysis and negotiated with the FTC and parties in this matter. We created Adams Supermarkets, a new local supermarket chain owned by Bozzutos Wholesale, Cheshire, Connecticut; divested stores to Shaws Supermarkets, a new and expanding entrant into Connecticut, to Ro-Jacks, a 5 store independent in Providence, and to others. Royal Ahold converted all its remaining Edwards to Stop and Shops.

In retrospect, the antitrust agencies should have challenged this merger rather than attempt to fix it via divestiture.<sup>4</sup> An extensive ex post analysis of pricing in many of the divested stores (Cotterill et al, 1999) supports this conclusion. The operators of the divested stores competed on price for several months, however, when Stop and Shop retaliated with lower prices

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<sup>4</sup> See Cotterill (2002b), Comments on the Food Marketing Institutes' Submission to the FTC Workshop Titled, "Supermarket Merger Investigations and Remedies." for a more detailed discussion for FTC divestiture practices.

in neighboring stores, after a few months of punishment, the operations of the divested stores caved in and followed Stop and Shop to higher price levels.

Ro-Jacks supermarket went bankrupt attempting to operate the five additional supermarkets that were much larger than its original five stores.<sup>5</sup> Two of the ten Adams Supermarkets are now closed and the chain has not grown.

Today, Stop and Shop is the unchallenged leader in Southern New England with market shares above 50% in many local “antitrust” market areas. Several other horizontal mergers, including Shaws 1999 acquisition of the Star Markets in Boston, have also contributed to the increase in supermarket concentration. Table 1 gives the market shares and four firm concentration ratios for the three aggregate IRI market areas that cover virtually all of Massachusetts, Connecticut, and Rhode Island (Trade Dimension, 2003). Market concentration and the trends to increased concentration reported in Table 1 are undoubtedly higher in smaller geographic antitrust market areas because chain stores are not uniformly distributed throughout an IRI area. Table 1 gives store numbers and market shares for the top four supermarket chains in 1996, 2000, and 2003 for each IRI area.

The Boston IRI area which is all of eastern Massachusetts except Cape Cod, is the least concentrated; however, the partial HHI (top four firms) increase from 1,325 in 1996 to 1,765 in 2003. Stop and Shop store numbers increases from 68 to 88, and its market share goes up from 26.2% to 32.8%. Shaws market share jumps to 26.7% in 2000 because it was allowed to acquire Star Markets. Note that its store numbers remained unchanged at 80 between 2000 and 2003, but it lost 4.5 market share points. The market positions of DeMoulas and Roche Brothers, two strong local chains, remained stable throughout this period.

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<sup>5</sup> At the time, the lead author of this testimony prepared an extensive report for the Rhode Island Attorney General, that recommended Ro-Jacks not be given the divested status and predicted their bankruptcy.

The Providence IRI area is the State of Rhode Island. The market share levels and trends document Stop and Shop's dominance in 1996 and growth into an even stronger dominant position. In 2003, Stop and Shop's share of supermarket sales was 51.5 percent. Its only significant rival is Shaws with a distant 20 percent of the market. The partial HHI is extremely high at 3,120 points.

The Hartford IRI market area includes virtually all of Connecticut and western Massachusetts. Again, Stop and Shop was the dominant firm in 1996 with 60 stores and a 40.4 percent share. By 2003 it expanded to 69 stores and 49.5 percent of the area's supermarket sales. The biggest loser was A&P who exited many markets in the area. A&P operated only nine stores in 2003, down from 35 in 1996, and its share was only 2.9 percent in 2003, down from 11.7 in 1996. Some of the stores that it sold were state of the art, recently constructed superstores, and curiously some were sold to Stop and Shop. In our opinion a sale to the area market leader should not have passed antitrust muster. If Stop and Shop and the acquired A&P were not in a more narrowly defined antitrust geographic market, one should revive the potential competition argument when dominance by Stop and Shop in the region is so pervasive. Price Chopper, a New York firm that has been trying to enter New England for years, is a more suitable buyer. The partial HHI for this very large IRI area has increased from 2,021 in 1996 to 2,695 in 2003. As in Providence, this is far above the federal merger guidelines upper threshold of 1,800.

Stop and Shop routinely engages in real estate practices that are explicitly designed to protect its market position. In Putnam, Connecticut, Stop and Shop has held the lease and kept a store empty (an old Edwards store) since 1996 in a downtown shopping plaza. It also has objected to the landlord renting an empty K-Mart Store in the same plaza to Price Chopper, a

formidable competitor, on the grounds that the lease for the dark Edwards prevents any other site in the plaza from being rented to a grocery store. Such exclusivity clauses are common in leases in shopping centers; however, it is most extraordinary for a supermarket to rent and hold empty a store in a center and then attempt to exercise the exclusivity clause to keep a supermarket out of another store site in the center.

As a result of Stop and Shop's actions, the shopping plaza has died and is an eye sore in the center of town. The town's library sits in the middle of this dilapidated strip mall. Consider the impact on kids that should be using the library. Civic pride suffers. In 1999 when we surveyed supermarket prices in 19 Royal Ahold stores in Connecticut and Pennsylvania we found a strong correlation between the HHI and Royal Ahold price levels. Putnam, with a single Stop and Shop, one smaller old supermarket was the most concentrated market. It also had the highest prices of all the supermarkets that we checked (Cotterill, 1999 p.16). Stop and Shop's motive seems clear. They exclude competitors and charge higher prices.

Figure 1 and 2 provide price evidence on milk pricing at Stop and Shop in the Hartford and Providence IRI areas. Note that after the Royal Ahold acquisition, Stop and Shop's milk price moved up in both market areas and remained higher than those of all other supermarkets. The crossover occurs earlier in Hartford than Providence possibly because the acquisition was completed earlier in Connecticut than in Rhode Island where the debate over divestiture to Ro-Jacks delayed settlement several months since 1996. Stop and Shop is the price leader in Southern New England for milk and has led prices up.

## **II.2 The Increase in Concentration in New England Fluid Processing**

Since 1972, the market structure of fluid milk processing in New England has collapsed to a single dominant firm, Dean Foods, with extensive private label processing, the Garelick fresh milk brand and other secondary brands. In July 1997, co-temporal with the Dairy Compact implementation, Suiza Dairy, the precursor of Dean Foods, purchased the Garelick Company and entered New England. In July 1998, Suiza purchased another leading New England milk processor, West Lynn Creameries; and in August 1998 it purchased yet another leading processor, Cumberland Farms. Cumberland Farms had a reputation for being aggressively competitive when bidding against Suiza/Garelick for private label contracts (Healy, 2000).<sup>6</sup> The Cumberland merger should never have been sanctioned by the antitrust authorities. Thereafter, Suiza purchased Natures Best Dairy in Rhode Island and attained control of New England Dairies in Hartford, CT through a joint venture with Dairy Farmers of America.

On June 1, 2000, Suiza/Garelick commenced supplying private label milk and Garelick brand milk to Stop and Shop. Prior to that, Stop and Shop processed its own private label milk in addition to processing and distributing the Hood milk that it sold in its supermarkets.<sup>7</sup> Moreover, Stop and Shop also controlled the marketing, including pricing of Hood milk in its

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<sup>6</sup> Several independent industry sources corroborate this fact.

<sup>7</sup> This is common knowledge in the New England dairy industry. Several independent industry sources corroborate this fact. Also, one can use the USDA Health Inspection Service plant numbers that by law are printed on every container to identify the processing plant. Hood milk sold in Stop and Shop had the same plant number as Stop and Shop private label during this era. Today, Stop and Shop and nearly all other private label milk in southern New England comes from plant no. 35-100, the Dean Foods plant in Franklin, Massachusetts that also bottles Garelick and Sealtest milk.

stores (Beatty). This means that for Stop and Shop there is no question over who controlled prices on 80 percent of the milk that it sold prior to July 2000.<sup>8</sup>

The 15-year strategic alliance contract (Gorenstein) that ties Stop and Shop to Suiza was scrutinized and modified by the New England state attorney generals on antitrust grounds.<sup>9</sup> The states alleged the following:

“the February 2000 transaction would increase concentration in the market for sale of fluid milk products in New England by reducing the level of milk processing capacity in New England that is not controlled by Suiza....Suiza could unilaterally exercise market power resulting in increased prices to retailers and consumers, and that the transaction would increase barriers to entry for Suiza’s competitors and potential competitors by making it more difficult for them to obtain capital to build capacity.” (Sorrell, June 25, 2001)

The consent decree provided the following resolution:

- “Suiza shall offer 30 million gallons of its New England milk processing capacity per year, for a period of five years, to its competitors. Competitors who want to utilize Suiza’s New England milk processing capacity will enter into processing agreements with Suiza.
- Suiza and Stop & Shop shall not honor their past agreement to restrict Stop & Shop stores from selling competitors’ milk or cream products, and shall not enter into any agreements in the future to restrict Stop & Shop stores from selling competing brands.
- Stop & Shop shall not sell the milk processing assets of the Readville plant to Suiza, and may only sell the assets to a party approved by the Vermont Attorney General.
- Suiza shall not purchase or otherwise acquire an ownership interest in any dairy processing facilities in New England without first notifying the Vermont Attorney General and allowing the Vermont Attorney General time to investigate the proposed transaction.
- Suiza shall not sell, close or cease operations of any New England dairy plants without first notifying the Vermont Attorney General.” (Sorrell, June 25, 2001)

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<sup>8</sup> A similar situation holds today in the Pacific Northwest where Safeway and Kroger (Fredy Meyer and Quality Food Centers) operate their own milk processing plants. The benefits of high retail prices accrue entirely to the integrated chain.

<sup>9</sup> The lead author of this testimony served as economic expert for the states.

In a separate agreement Suiza agreed to continue purchasing its raw milk from Stop and Shop's traditional supplier, St. Albans cooperative. Leon Berthiaume, General Manager of the St. Albans Dairy Cooperative, said:

“We appreciate the extensive efforts of the Vermont Attorney General's Office to protect the interests of consumers, farmers and processors in our state. The results of this process will prove to be beneficial to all interested parties.” (Sorell, June 25, 2001)

John Kaneb, President of HP Hood Inc., a company whose products would have been disadvantaged by the agreement, also praised the settlement:

“I congratulate the Vermont Attorney General on bringing about a result that helps preserve competition in the New England dairy industry, while allowing a commercial transaction between private parties to go forward. This is constructive antitrust policy in action.” (Sorrell, June 25, 2001)

Table 2 gives an estimate of the market shares in all of New England for the leading milk processors for the year ending June 30, 2000. We have no more recent data; however, these shares are reasonably accurate today. Before the Stop and Shop private label contract Suiza/Garelick accounted for 44.8 percent of fluid milk sales to supermarkets. This is more than twice the share of the number two processor, Hood. Suiza/Garelick is nearly three times larger than Hood if one removes the Stop and Shop Hood milk from Hood's share. After the June 2000 closing of the Stop and Shop plant, Suiza controlled 63.7 percent (44.8 + 18.9) of the New England supermarket channel. This market share may have increased since then because in the 15 year strategic alliance, Stop and Shop clearly has less incentive to sell Hood milk (Baily, March 24, 2000).

After the consummation of the Stop and Shop deal, Suiza/Garelick may sell more than four times the volume of milk than its nearest competitor, Hood, sells in New England. The

Suiza/Garelick market share in the smaller Boston IRI market is even higher and probably falls in the 80-90 percent range after the Stop and Shop acquisition.

Strictly speaking, these market share estimates are for the supermarket channel; however, Suiza/Garelick's dominance in other channels is most probably similar. There are very few alternative suppliers. Also, one could include milk plants around Albany, New York in the market. Both Suiza and Crowley have plants there. Such changes do not alter the following conclusion. By 2000, Suiza was unmistakably the dominant milk processor in New England.<sup>10</sup>

As Suiza acquired its market share, it actually closed or caused the closure of several very substantial milk plants including the Stop and Shop Readville, MA plant, the New England Dairies plant in Newington, CT, and the Cumberland Farms-Massachusetts plant. Today it operates two large plants in southern New England in the Boston IRI market area (Franklin, MA and West Lynn, MA). Suiza's East Greenbush, New York plant near Albany and two smaller plants in Vermont and Maine also supply milk to New England. As a result of Suiza's related plant closings, by 2000 there was dramatically less processing capacity in New England and little excess capacity outside of the Suiza plant system (Healy, 2000).<sup>11</sup>

Suiza's rise to dominance in the New England market was associated with a visible elevation and changed pricing philosophy relative to Hood. In Figure 3, the Garelick and private label retail price moves in 1999 and 2000 that widen the marketing margin are at least in part due to price leadership by Suiza-Garelick at the processor level.

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<sup>10</sup> Lest one think that this dominance does not effect conduct. Industry executives now request anonymity when providing information for fear of retaliation by Dean Foods.

<sup>11</sup> In response to the disappearance of capacity and increased demand for an alternative to Dean Foods, Guida-Siebert Dairy, New Britain, Connecticut expanded capacity in 2001. Plant numbers on milk bottles and information from Alex Guida, president of Guida-Siebert Dairy indicate that it now supplies BIG Y, a regional chain, with private label milk.

The only other explanation for the disappearance of the gap between Hood and the other two products in Figure 1 is that retailers exclusively controlled the retail prices and priced in a fashion to generate a very significant shift in volume away from private label and Garelick to Hood.<sup>12</sup> In fact for the market leader, Stop and Shop, the incentive was to disadvantage Hood.

On April 5, 2001, Suiza Foods, the number two fluid processor in the nation, announced that it was merging with Dean Foods, the nation's largest processor, to create a company named Dean Foods that would control approximately 40% of the nation's fluid milk processing. In many regional fluid processing markets, but not New England, this merger created serious antitrust problems. After negotiation with the U.S. Department of Justice, Antitrust Division, the merger was consummated in December 2001. The DOJ required Dean to divest 11 fluid milk plants to three individuals and Dairy Farmers of America, who sold its 1/3 interest in Suiza back to the company. DFA and the private owners each own one half of the newly created company, National Dairy Holding (U.S. DOJ, 12/18/2001; PR Newswire, 12/21/2001). Dean remains the nation's largest fluid processor with \$8.12 billion in sales in 2002, and NDH is the third largest with \$2.3 billion sales (Dairy Field, 6/2003)<sup>13</sup>. Soon thereafter National Dairy Holdings acquired Crowley Foods (Binghamton, NY) from a Dutch multinational. In that deal, NDH entered the New England fluid market because Crowley owns Weeks Dairy in Concord, New Hampshire, and a fluid plant near Albany that can ship into New England.

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<sup>12</sup> See Cotterill and Tian (2003) for estimation of Hood, Garelick, and private label demand curves for the Boston market.

<sup>13</sup> Kroger, the nation's second largest supermarket chains, is the number 2 processor with sales of \$2.8 billion.

### **II.3 The Increase in Concentration in Fluid Milk Assembly and Vertical Relationships with Processors.**

Both the National and the New England fluid milk industries are an example of the replication hypothesis, a venerable idea from industrial organization theory. As economic concentration occurs at one stage in a multistage channel, the replication hypothesis predicts concentration increase at other stages in the channel. Indeed, large fluid milk processors and large fluid milk cooperatives often assert that “the demands” of serving dominant supermarket chains that are national, or at least multi-regional in scope, has driven consolidation in fluid processing and that in turn has driven consolidation in cooperative milk assembly.

Until recently, milk assembly in New England was easily classified into three primary groups. The Agrimark cooperative was the largest player supplying milk to many fluid processors including Hood and Guida, current Agrimark customers. The St. Albans Cooperative shipped all of its fluid milk to the Stop and Shop milk plant. The third block of milk in New England was from independent farmers that Garelick, among others, had under contract. Agrimark and St. Albans supplied well over 50% of the fluid milk in the New England fluid milk market order prior to its consolidation in 2000 into the new Northeast milk market order that includes New York, Philadelphia, and Washington DC.

Today the situation is very different. It also is very unstable because of continuing instability in the structure of fluid milk processing in the region. The predecessor to Dean Foods, Suiza Dairy, was 1/3 owned by Dairy Farmers of America (DFA). Suiza Dairy had a fluid full supply contract arrangement for milk from DFA in regions where DFA offered milk. In the northeast, DFA includes the former Eastern Milk Producers Cooperative of NY. Eastern was a part of Milk Marketing Inc, Strongville, Ohio and it merged with two Midwestern cooperatives to form DFA. DFA strengthened its position in the northeast in 1999 by forming a marketing

agency in common, named Dairy Marketing Services (DMS), with Dairylea, the leading dairy cooperative in NY (Associated Press, 9/2/99). Suiza Dairy (1/3 owned by DFA at this time) then strengthened DMS by making it the milk assembly agent for its independent farmers nationwide. This included the independent farmers in New England. St. Albans joined DMS because its access to the fluid milk market via the Stop and Shop/Suiza agreement expires in 2006. Finally the NDH (50% owned by DFA) plants in Concord, NH and near Albany, NY are also under full supply contracts with DMS. In New England these moves have made DMS the major fluid milk assembler with Agrimark, a distant second.

Looking to the Northeast, Atlantic Dairy Cooperative was the supplier of as much as 80% of the fluid milk to the Philadelphia market order that was merged into the Northeast Order in 2000. It was acquired by Land O'Lakes. In August 2003 Land O'Lakes fluid milk assembly in the Northeast also joined the DMS marketing agency in common (The Business Journal, 8/4/03). DMS now supplies Dean Foods and National Dairy Holdings plants in New York, New Jersey, and Pennsylvania as well as New England. These plants are dominant in the northeast fluid market.

What are the impacts of the consolidation of milk assembly under the DMS banner? DMS promotes itself as a harbinger of efficient milk assembly, thereby lowering hauling charges and improving farmer mailbox prices.

“Dairy Marketing Services (DMS) is a milk marketing organization formed for the purpose of creating efficiencies and reducing costs of milk assembly, field services, and transportation. It serves farmers by working to streamline the milk marketing system, and serves processors by being better able to meet their needs.” (Dairy Marketing Service, 2003).

Undoubtedly these are legitimate efficiencies. But we doubt that they are more than a few cents per hundredweight. For example, nearly all of northern Vermont milk in the DMS system today

was assembled in St. Albans and that will not change. In Pennsylvania all milk in the DMS system was assembled by Atlantic Dairy/Land O'Lakes and that will not change. In upstate New York, Dairylea, DFA, and independents shipping to Dean and NDH (Crowley) may have had overlapping costs that can be rationalized. However, that gain may not be large for larger farms that can fill a tanker or a large part of a tanker.

On the other side of the accounting ledger several antitrust concerns surface. Does DMS have monopsonistic power against farmers? Does DFA have undue influence over DMS and consequently do northeast dairy farmers lose? DFA is a multinational operation with its roots in the Midwest. Also it is a "top down" organization that behaves more like a proprietary firm than a cooperative. This may have benefits, but it leads northeast farmers to question whether it represents and acts in their best interests. Does DMS have monopolistic power in the raw milk market that enables it to extract large over-order premiums from processors and retailers?<sup>14</sup>

These questions are very hard to answer with empirical evidence at this time because the DMS/DFA track record is very short. For insight, let's retreat to the documented structural changes in the dairy channel, the profit maximizing drive by all players in the channel including farmers via their cooperatives, and the economic implications of these two facts. Structurally we have dominant firms or tight oligopoly in nearly all local retail markets. We have dominance in many regional fluid milk processing markets and we have a dominant cooperative agency assembling milk. This means that many fluid milk marketing channels are faced with the successive firms with unilateral market power.

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<sup>14</sup> DFA field representative (not DMS) has used the promise of cooperative power in presentation to potential member in New England. To date the primary manipulation had not been in fluid milk processing. It is the Cooperatives Working Together (CWT) program which is in our opinion, and the opinions of other agricultural economists, an ill-fated attempt to control supply. When it comes to supply control cooperatives are not as well suited as the federal government, which can eliminate free riders.

Elsewhere, we have written about the problem of double or in this case triple marginalization in a marketing channel (Cotterill 2001, 2002c). As these successive firms move to exercise market power against consumers the tendency is to elevate prices too high, damaging channel profits as well as consumers. One needs a vertical strategic alliance to internalize this pricing externality, i.e. the participants at the three steps of channel must jointly set the retail price and agree upon the division of the resulting profits. One must ask if this type of vertical price fixing is legal? Is it subject to a rule of reason test that balances market power from vertical cooperation with efficiency gains from eliminating double or triple marginalization? In other words, do these vertical strategic alliances between retailers and processors, and between processors and cooperatives create barriers to entry that enhance the partners' ability to deviate from competitive pricing? Clearly the New England Attorney General thought this to be the case in the Stop & Shop/Suiza-Dean strategic alliance.

This leads us to a current antitrust matter, the proposed merger between NDH and Hood in November 2002 (Cohen, 8/4/2003). This proposed merger would combine Hood and the Crowley Albany and Concord plants. This horizontal merger should not be allowed from the consumer's side because it reduces competition in the highly concentrated New England fluid market. A cogent argument can also be made from the farm side of the market. The Agrimark Cooperative would lose its fluid milk sales to Hood because NDH/Hood would move into the DMS/DFA full supply contract camp. This fluid loss threatens to depool Agrimark from the fluid milk market order because the coop may consequently sell less than 20% of its members' milk in Class 1. Agrimark members would then be paid lower cheese milk prices rather than the higher blend pure that include sales at the higher Class 1 price.

Due to strong resistance from the state and federal antitrust agencies and elected representatives, NDH and Hood withdrew their merger proposal on May 12<sup>th</sup>. At that time, they announced a co-mingling of ownership rather than outright merger between NDH, Hood, and DFA. This second proposal is still under review. Again any form of interlocking directorship or management between Hood and Crowley will damage competition in fluid processing in New England.

If the combination transfers Hood fluid needs to DMS, Agrimark's alternatives include selling sufficient Class 1 milk at more distant fluid plants in the order (New York City, New Jersey) which would increase transport cost deductions for its members. The other option is to join DMS and effectively complete the monopolization of fluid milk assembly in the northeast.

If DMS in fact does achieve a monopoly on milk assembly in the northeast; will it be able to extract over-order premiums from processors and retailers? We think not. If DMS attempts to do so then Dean Foods could counter by retrieving its independent farmers and resorting to traditional pool busting pricing practices as in the RCMA era in the early 1990s in the northeast. In short, DMS can capture legitimate efficiencies, but it may be pushing on a rope if it attempts any significant over-order pricing in the northeast. This also suggests to us that in any tripartite division of profits, DMS will come up short because it has the weakest bargaining position. Processors and retailers have far stronger positions.

### **III. Recent Price Performance in the NY and New England Fluid Milk Marketing Channels: the Impact of Public Policies and Private Power**

Events in the northeast dairy industry including changing market structures and changing federal and state dairy policies have had dramatic effects on the performance of fluid milk marketing channels. In 1991, New York passed a price gouging law that limits retail prices on

one brand of milk to no more than 200% of the price paid for 3.5% raw fluid milk. This raw price includes over-order premiums that raise price above the announced federal order Class 1 price. At that time, the New York legislature also passed a law that gave the state the authority to levy over-order premiums for farmers. This subsequent law was declared unconstitutional. In effect, downstate consumers interests received their part of the logroll, but upstate farmers were denied theirs.

Why did the NY legislature pass these two laws? Huff (2003) documents that farmers were suffering from an extended period of low milk prices and downstate retail prices remained high. The lack of effective price transmission hurt consumers who continued to pay high prices and farmers because fluid consumption did not increase. Clearly the NY legislature wanted to elevate raw fluid milk prices and eliminate price gouging by channel firms.

A similar but longer raw fluid price trough occurred between October 2001 and July 2003. Figure 4 illustrates the situation for Boston. The two vertical lines indicate the period when the Northeast Dairy Compact was in effect with its price floor at \$1.46 per gallon (\$16.94 per cwt). Between October 2001 and January 2002, raw milk prices measured by Class 1 plus coop premium price series, dropped 34 cents per gallon. This price fell another 22 cents by July 2003, for a total decline of 56 cents per gallon. Retail prices dropped only 10 cents. What is going on?

Agricultural economists have traditionally analyzed this price transmission problem by correlating the retail price with the farm price, controlling for changes in the prices of other impacts. The challenge to this approach is to find a good measure of other input prices. Moreover, the retail price series in Figure 4 is only for whole milk, price checked at two chain stores and one convenience store. It may not accurately reflect retail prices. Also, one routinely

does not have a wholesale price in these studies so one cannot determine margins at the processing and retailing stages of the channel.

Over the past year at the University of Connecticut we have developed a different analytical approach. In November 2002, we surveyed prices in 191 stores from 35 grocery firms located in NY, CT, MA, and RI (Cotterill et al, 2002). We found that retail milk prices in supermarkets were 59 cents per gallon lower, on average, in NY than southern New England. We were able to confirm the average milk price reported for November in Figure 4 but also provide pricing details for individual chains and types of milk.

We repeated a mini survey in March 2003 of the leading chains in Connecticut and added a critical component to our analysis. We obtained wholesale milk prices, i.e., the price the processors charge for delivering bottled fluid milk into the dairy case coolers of supermarket chains, from Dairy Technomics. This firm routinely measures raw milk prices, processing, and delivery costs for supermarket chain buyers who use the information to bargain for lower wholesale milk prices. Dairy Technomics estimates are for specific plants and for deliveries to specific chains. Dairy Technomics estimates have been verified as accurate by milk processors and by outside audit (Cotterill, 2003). For example, we found that Dean Foods delivers gallons of private label and Garelick milk from its Franklin, MA plant to Stop & Shop under its 15-year strategic alliance for the price it pays for raw milk plus 52.5 cents per gallon. Dean delivers the same milk from the same plant to all other chain supermarkets in southern New England for the same raw pay price plus 61.5 cents per gallon (Cotterill et al, 4/23/03).<sup>15</sup> The Dairy Technomics estimates allow us to determine the wholesale price, processor and retail gross margins.

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<sup>15</sup> This suggests that other retailers may have a secondary line Robinson-Patman case against Dean. They do pay higher prices than Stop and Shop that probably are not cost justified. However, Stop and Shop has not used their cost advantage to damage the other chains. They have exercised price leadership, elevating retail prices so a R.P. suit fails because the plaintiffs are not damaged.

Our results for March 2003 are reported and discussed elsewhere (Cotterill et al, 4/23/03, Cotterill, 2003). Appendix Figure 1 to this testimony displays chain and brand level prices for March 2003.

In June 2003, in cooperation with the NY Attorney General, we conducted an extensive survey of New York and a replication of the November survey. We also obtained processor costs by plant for delivering to different supermarket chains from Dairy Technomics. Price survey results are reported in Rabinowitz et al (2003). Also see the Cheese Reporter article attached in Appendix B for an excellent review of results. This week (October 26-31, 2003) we are again surveying the same stores and obtaining Dairy Technomics estimates for the processing stage.

This series of surveys over a year where, as documented in Figure 4, farm prices were low, continued to fall and recently increased dramatically will allow us to analyze channel margins over time and changes in them as well as retail prices as farm price changes. Moreover, we can analyze changes under the price gouge law in NY and compare them to New England where there is no such law. We also can analyze price changes by brand in each of several firms including some who operate in NY as well as New England.

Since we have not had time to analyze the October 2003 data, we focus on June 2003 prices and a comparison to November 2002. The weighted average all milk price for supermarket chains in New England in June 2003 averaged \$3.01 per gallon, the same as we found in November 2002. By comparison the average price for supermarkets in NY was \$2.31 per gallon, down 11 cents from their November 2002 price. Two major conclusions follow. First, milk is 70 cents per gallon cheaper in the surveyed NY area (Long Island, metro NY city and the Hudson river valley up to Albany) than in southern New England. Second, when the raw

fluid price dropped eight cents a gallon in Boston retail prices did not drop in New England but they did in New York. We concur with Huff (2003). The NY price gouge law improves farm to retail price transmission.

Table 3 reports all milk prices for individual chains in NY and in New England. Note that Stop & Shop charged \$3.21 per gallon, up 3 cents from November in New England, whereas in NY the chain charged only \$2.45 per gallon, down 14 cents from November. One observes similar differentials for other chains that operate in New England and New York. Wal-Mart however is an exception. Wal-Mart charged \$2.54 per gallon in June 2003 in New England down 25 cents from its November 2002 price. Wal-Mart appears to have responded to our call for lower milk prices in New England (Cotterill, 2002a). Wal-Mart prices in NY are lower at \$2.10 per gallon, however they dropped only 5 cents from November 2002.

Figure 5 is the most important chart in this testimony. It gives the raw milk prices by brand for each of the top four supermarkets in southern New England. It also gives the Dairy Technomics wholesale dollar margin for each brand. The sum of the processor margin and the raw milk price is the wholesale price for milk delivered into the coolers at the chains stores. Finally, Figure 5 gives the retail dollar margin and the retail price by brand for each of the four chains.<sup>16</sup>

The first column in Figure 5 is the all milk average for southern New England. Processors paid farmers \$1.031 per gallon and collected 59.6 cents per gallon for processing and distribution of milk to supermarket chains. The average wholesale price was \$1.627 per gallon. The average retail milk price is far higher—\$3.07 per gallon. Supermarkets kept \$1.447 per gallon, nearly half of the retail price for in store costs and profits. Research at the University of Maine and Penn State University indicate that in store costs for large chain stores is as low as 20

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<sup>16</sup> See Rabinowitz et al (2003) for survey details.

cents per gallon and ranges up to 40 cents per gallon in smaller supermarkets (Pennsylvania Milk Commission 2000, Maine Milk Commission 2002). We conclude that these large supermarkets are charging on average at least a dollar per gallon more than they would be able to charge in a competitive market channel. Note that the overcharge varies by brand and by location. Private label milk is lower priced and DeMoulas has distinctly lower prices than the other chains. DeMoulas retail margins are far lower than margins in the other chains.

Figure 5 also reveals a very extraordinary relationship between retailers and processors. Hood, Garelick, and Guida have developed their branded milk products, but the retailers are capturing virtually all of the brand equity. Examine, for example, Hood milk that is sold at Stop & Shop. Hood charges Stop & Shop \$1.69 per gallon at wholesale and keeps only 66 cents after paying farmers \$1.026 per gallon. Stop & Shop adds \$1.82 per gallon and retails the Hood milk at \$3.51 per gallon. Again, the in-store cost of selling Hood milk is less than 40 cents per gallon. Thus, Stop & Shop is capturing a hefty premium, virtually all of Hood's brand equity. The same is true for the other two brands of milk, Garelick and Guida, in Figure 5.

Now let's restate these prices on a per hundredweight basis to focus on the issue of price enhancement via public policy (i.e. the milk market order) versus price enhancement via the exercise of private economic power in the channel. At \$3.07 per gallon consumers are paying \$35.70 per cwt for fluid milk. Processors are paying farmers  $\$1.031 \times 11.6279 \text{ gal/cwt} = \$11.99$  per cwt for this milk. (Since much of the milk is skim/low fat, this pay price does not include excess cream.) A recent FAPRI study suggests that eliminating the federal market orders would reduce processor pay prices by roughly \$1.50 per cwt (Brown). This elimination of "public power" pales in comparison to the  $\$1 \text{ per gallon} \times 11.6279 \text{ gal/cwt} = \$11.63$  per cwt market power premium that supermarkets are extracting from consumers.

Private economic power and excess milk profits outweigh federal market order price enhancement by a ratio of 7 to 1 in New England. Those who think doing away with federal market orders would benefit consumers and farmers in low fluid utilization areas (e.g., upper Midwest) due to lower retail prices and increased fluid milk consumption need to think again. The primary beneficiaries of order deregulation may well be processors and retailers.

Moreover, the use of private power in the channel is destroying the economic basis of the orders. Retailers will elevate milk prices until the demand for milk becomes elastic, i.e., the percent decline in milk sold is greater than the percent increase in price. When milk prices are elastic the Class 1 price discrimination scheme of the federal orders reduces rather than increases the blend price that farmers receive. At that point, private economic power completely destroys the classified pricing system of the federal orders.

#### **IV. The Impact of Market Power on Northeast Dairy Farmers**

A critical question remains for analysis. Is the margin enhancement due to the exercise of market power against consumers or is it also due solely to the exercise of market power against northeast dairy farmers? We can actually answer this question by referring to the Jesse et al quote at the beginning of this testimony and the related federal market order reforms that occurred during the 1990s. Class 1 differentials were reduced, effectively leveling the geographic impact of the market order system's price discrimination scheme. Today, Class 1 milk at the Eau Claire, Wisconsin basing point is \$1.70 per hundredweight over the manufacturing milk price. This amount is the price discrimination component (assuming no higher costs for supplying fluid) that is common to all federal milk market orders. This Class 1 differential increases as one moves east until it is \$3.25 per hundredweight in Boston. If the

manufacturing milk price is \$9.75 per cwt, as it was in June 2003 then the Class 1 minimum in Wisconsin is  $\$9.75 + \$1.70 = \$11.45$  per cwt and it is  $\$9.75 + \$3.25 = \$13.00$  per cwt in Boston. Jesse et al calls the geographic components of the Class 1 differentials “pricing distortions” and states that these are now so low that competition sets regional milk prices:

“...competition has operated both within and outside the orders to mitigate the effect of these pricing distortions. For example, low Class 1 differentials in Wisconsin are augmented by large over-order Class 1 price premiums negotiated by cooperatives. Cooperatives premiums are relatively low in other markets and nonexistent in some. This tends to equilibrate effective Class 1 prices, even though the order minimum prices may be distorted. ...” (Jesse et al, 2002 p.21)

Since manufacturing milk prices are identical in Wisconsin and Boston, any geographic federal order distortions disappear when fluid market prices set by over order premiums. This means that the reported mailbox prices for Wisconsin and the northeast, i.e. the prices that farmers actually receive for their milk are geographically competitive prices that reflect the supply and demand for milk throughout the nation.

Let’s look at those mailbox prices for Wisconsin and the northeast. Table 4 reports them for 2002 and the final seven months of 2003. In 2002 the Wisconsin mailbox price averaged \$12.02 per cwt whereas in the northeast it was LOWER at \$11.89 per cwt. For 2003 to date they are essentially equal but in July 2003 the northeast mailbox price at \$11.63 was 63 cents LOWER than the Wisconsin price, \$12.26.

In a geographically competitive raw milk market, the mailbox prices in the northeast should be higher not lower than those in Wisconsin. As one moves east from the Midwest prices should rise by the transportation costs. They do not.

Alternatively, northeast milk prices at \$11.89 per cwt are clearly below the cost of production for virtually all dairy farmers in the region. If a number of them go out of business and one has to haul milk or dairy products from Wisconsin, one will have to pay farmers there

\$12.02 per cwt or more for their milk and also pay the transportation cost to the northeast. Milk and dairy product prices in the northeast will be higher not lower as northeast dairy farmers go out of business and product comes in from Wisconsin.

Jesse et al state that in “deficit milk markets”:

“... Setting minimum prices at levels that promote year-round local fluid milk self-sufficiency is inefficient relative to setting prices that result in a combination of local production and shipments from other markets. ...”

We disagree with this presumption for the northeast given current market conditions. As our farmers go out of business, milk and milk products from the Midwest will cost consumers more not less.

So why are mailbox prices less in the northeast than the Midwest? The answer is that retailers and processors in the northeast are not paying over-order premiums that are as high as those in the Midwest. Also cheese plants in the northeast are not paying premiums that are as high as the cheese milk premiums in Wisconsin. Northeast raw milk markets, relatively speaking, are dominated by the milk channel firms at the expense of the region’s dairy farmers. Monopsony power the northeast dairy markets is a major force.

Professor Jesse from the University of Wisconsin understands this situation. As reported in a recent Cheese Report article he recognizes that Wisconsin farmers have benefited from cheese premiums as well as over-order Class 1 premiums. He also recognizes that it may be hard to maintain cheese premiums in the face of the expansion of cheap milk in the far west and new cheese plants out there.<sup>17</sup> Among others he sees the following solution: a shift up from 10% of

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<sup>17</sup> Northeast farmers have often been admonished for wanting higher Class 1 prices because they would contribute to over production of milk. Jesse et al (2002) and many others make this link. Consider the following facts. In 2002, there were 255 thousand dairy cows in New England, down 7 thousand cows from 2 years earlier. During the same two years, California, Idaho, and New Mexico EXPANDED their herds by 220 thousand cows (USDA, 2002 and 2003b). Higher fluid milk prices in New England would have virtually no impact on the national supply situation. The problem is in the west and must be dealt with there or at the federal level.

Wisconsin cheese production in value added specialty cheeses where the premium can be maintained and the capture of more of the east coast fluid milk market (Mueller, Sept 12, 2003).

“Jesse leaves the door open, however, for the possibility that Wisconsin’s average milk price will not be lower relative to the national average. For that to happen, ..., milk production would have to continue to fall in the East in order to open that market there for fluid milk from Wisconsin, and the state’s dairy processing industry would have to shift significantly from the production commodity cheese to more specialty cheeses (about 10 percent of the state production now)” (Mueller 2003).

On the scope of fluid milk markets Jesse et al clearly think the market is now national.

They state:

“Recognize the national scope of fluid milk markets. Policies need to recognize that dairy products – including fluid milk – trade in national markets. The concept of a local milkshed became obsolete when grocery chains began to maintain national distribution systems for both perishable and nonperishable items.” (Jesse et al, 2002)

Dairy processors also think this way.

“By pasteurizing and homogenizing, and blow molding and filling bottles in a sterile environment, Dean now produces milk-based drinks that don’t require refrigeration and can sit on a shelf for 150 days. Instead of delivering directly to stores, Morningstar can ship drinks through a network of warehouses and sell them in soda aisle of grocery stores. At \$12 million per filling line (which can do 18,000 bottles per hour), the technology doesn’t come cheap. But, as Engles points out, ‘somebody was going to do this. We’re trying to be first.’ And, of course, biggest.” (Cook, 2003)

One should regard this trade puffery with a strong dose of skepticism.<sup>18</sup> We would stress that the national fluid market that Jesse et al and Dean proclaim is not here yet and may never be the predominant fluid milk market structure. Fresh milk is still in most situations produced reasonably close to where it is consumed, and we would maintain that a low cost supply of fresh milk in the northeast will continue to be produced for the foreseeable future in the northeast.

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<sup>18</sup> In 2000, a top Suiza Dairy executive regaled a conference of agricultural economists with grand predictions for their new milk products, “Kids Milk” and “Life Milk.” These products were to appeal to moms who wanted to get more calcium, and vitamins into their kids and young adults. At over \$4.50 per gallon they have been noticeably unsuccessful.

## **V. Antitrust Policy and Dairy Policies Need to Address the Low Raw Fluid Milk Prices in the Northeast**

What does the rise of private pricing power in the dairy marketing channel suggest for dairy policy? We think there are two avenues. First at the federal level one could restore Class 1 differentials to levels that limit the exercising of channel firms power against farmers. After all one of the original reasons for establishing market orders was to countervail channel firm market power and restore “orderly” marketing to the milk industry. Alternatively, regional milk pricing policies in areas where this problem exists are in order to elevate farm prices.

Antitrust enforcement that prevents further consolidation also is a good idea. But in many regions, shutting this door does no good because the horse is already out of the barn. Recently, in Chicago, a consumer class action lawsuit against the dominant supermarket chains, Jewel and Dominick’s failed because the price leadership scheme they use is not price fixing. Jewel sets a high price. Dominick’s and others match that price. Since no one talks (conspires) with others to set the price, their conduct is legal (Zimmermann, 2003).

When antitrust is ineffective, economists look to regulation to improve economic performance. The New York price gouging law limits retail price to no more than 200% of the raw milk price processors pay. Prices, on average, in New York are 70 cents per gallon lower than in New England. New England states are now considering such laws, but these only benefit consumers.

Another alternative is a price collar at the processing as well as retail level; as was recently proposed in Connecticut (Cotterill et al 2003).<sup>19</sup> A 140% price collar on the wholesale

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<sup>19</sup> See Appendix B, *Cheese Reporter* article, “Controversy Over Level Of Farm Versus Retail Milk Prices Continues” and “A letter to the editor in response to the “Controversy Over Level Of Farm Versus Retail Milk Prices Continues” for more explanation of the price collar proposal.

price provides an incentive for processors to pay higher over-order premiums to farmers. Alternatively, they lose money along side farmers in low raw price markets. Processors need 60 cents per gallon to cover their costs. At \$1.00 per gallon raw milk price they can charge retailers only \$1.40. If they pay farmers an additional 50 cents, then the raw price is \$1.50, and they can charge \$2.10 and recover the 60 cents. Placing a 130% price collar on retailers means retailers can charge up to  $1.3 \times 2.10 = \$2.73$  per gallon. Consumers pay 34 cents per gallon less than \$3.07 per gallon, and farmers gain 50 cents per gallon. Given that farm milk prices are severely depressed, this reallocation of income in the channel may be appropriate.

The bottom line is this. Vigorous antitrust enforcement is important, but it may be time for policy makers to re-examine fluid milk channel pricing and to consider new approaches to dairy policy. One has opportunities to argue for regional milking pricing policies that promote dairy farming in regions such as New England by promoting more efficient as well as more fair milk market channel pricing. Doing so also preserves the effectiveness of classified pricing under the federal orders.

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Table 1. IRI Market Area All Product Market Shares and Number of Stores of Leading Supermarket Chains, 1996, 2000, and 2003.

IRI Market Data	1996		2000		2003	
	Number of Stores	Share	Number of Stores	Share	Number of Stores	Share
<b>Boston</b>						
Stop & Shop	68	26.2	77	28.5	88	32.8
Shaws	47	16.9	80	26.7	80	22.2
Demoulas	33	13.1	33	12.6	34	13.3
Star Markets	38	13.5	-	-	-	-
Roche Bros.	13	5.1	13	4.5	14	4.8
CR <sup>4</sup>		69.7		72.3		73.0
Partial HHI		1325.9		1704.2		1765.2
<b>Providence</b>						
Stop & Shop	19	46.8	20	48.0	23	51.5
Shaws	11	17.8	13	23.8	14	20.4
Edwards	6	8.7	-	-	-	-
RoJacks	2	2.8	6	8.8	3	3.7
Daves	-	-	6	3.2	6	6.0
CR <sup>4</sup>		76.1		83.9		81.6
Partial HHI		2590.6		2958.9		3120.1
<b>Hartford</b>						
Stop & Shop	60	40.4	61	42.2	69	49.5
Big Y	31	13.9	32	15.4	35	14.0
Shaws	13	7.7	16	7.6	15	6.1
A & P	35	11.7	20	7.0	9	2.9
CR <sup>4</sup>		73.7		72.1		72.5
Partial HHI		2021.6		2123.2		2695.1

The Partial HHI is the sum of the squared market shares of the four leading firms presented in this table.

Source: Calculated from Trade Dimensions *Market Scope 1997, 2000 Update and 2003 Mid-year Update*. Systems, Wilton, CT.

Table 2: Volume of Milk Sold to Supermarkets and Market Share by Manufacturer: All New England, July 1999 through July 2000.

	Million lbs	Share
Suiza (Garelick and PL)	652.99	44.8%
Stop & Shop (PL)	275.26	18.9%
Total Suiza after 6/1/2000*	928.25	63.6%
Hood (Stop & Shop)	69.4	4.8%
Hood (All Other)	222.6	15.3%
Combined Hood	292	20.0%
Guida	96.02	6.6%
Crowley	33.69	2.3%
Oakhurst	108.79	7.5%

\* Effective June 1, 2000, Suiza began supplying Stop & Shop private label milk under a 15-year contract. The Stop & Shop plant was closed.

Source: Calculated from Food Marketing Policy Center IRI database.

Table 3: Weighted Average All Milk Prices by Chain November 2002 vs June 2003

Chain	New England		New York	
	June 2003	Change from Nov 2002	June 2003	Change from Nov 2002
Stop & Shop	3.12	0.03	2.45	-0.14
Shaw's / Star Market	2.97	-0.01	-	-
DeMoulas / Market Basket	2.49	-0.05	-	-
Roche Bros	2.83	0.10	-	-
Big Y	2.92	-0.13	-	-
A & P / Waldbaums	3.15	0.00	2.52	-0.18
Shop Rite	3.15	0.25	2.24	-0.20
Price Chopper	3.26	0.09	2.23	-0.10
Ro Jacks	3.07	0.04	-	-
Hannaford	N/A	N/A	2.24	-0.09
King Kullen	-	-	2.44	-0.13
Wal-Mart	2.54	-0.25	2.10	-0.05
Pathmark	-	-	2.44	-0.13

Note: - means chain not in area, N/A means no observations in data

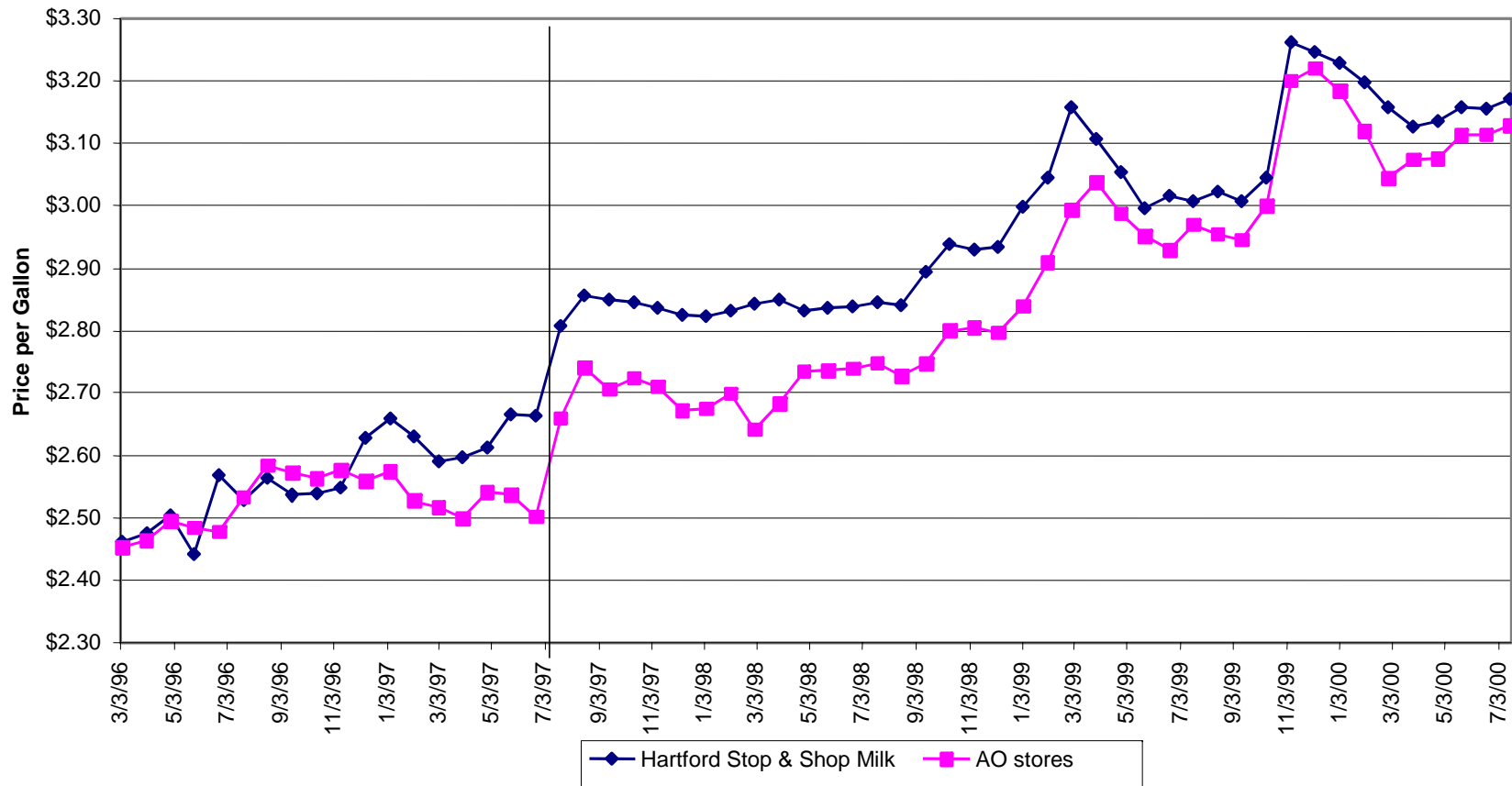
Source: Food Marketing Policy Center Survey November 2002 and June 2003.

Table 4. Federal Milk Order Mailbox Prices for 2002 and 2003 by Month and Annual Average

	Northeast	Wisconsin
January 2002	13.24	13.57
February	12.91	13.12
March	12.48	12.45
April	12.05	12.48
May	11.74	12.16
June	11.49	11.42
July	11.14	10.61
August	11.25	10.98
September	11.29	11.46
October	11.74	12.38
November	11.65	11.83
December	11.58	11.78
January 2003	11.62	11.59
February	11.22	11.28
March	10.86	10.70
April	11.06	10.85
May	11.10	11.04
June	11.07	10.90
July	11.63	12.26
2002 Average	11.89	12.02
2003 Average	11.22	11.23

Source: USDA Agricultural Marketing Service

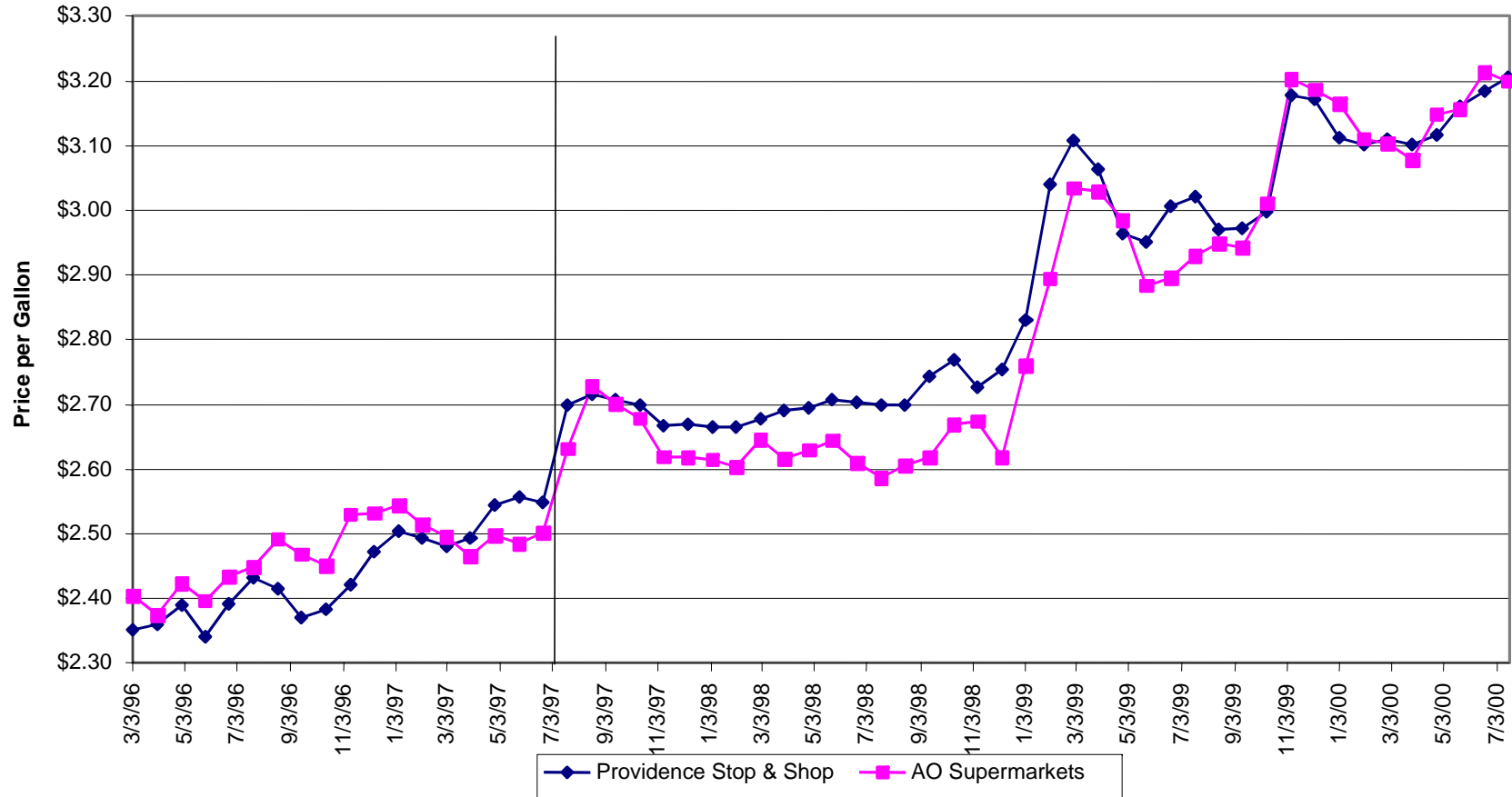
**Figure 1.** Hartford  
**Stop & Shop vs All Other Supermarkets**  
**Market Level Milk Price**  
**March 1996 - July 2000**



Source: Calculated from Food Marketing Policy Center IRI database.

Figure 2.

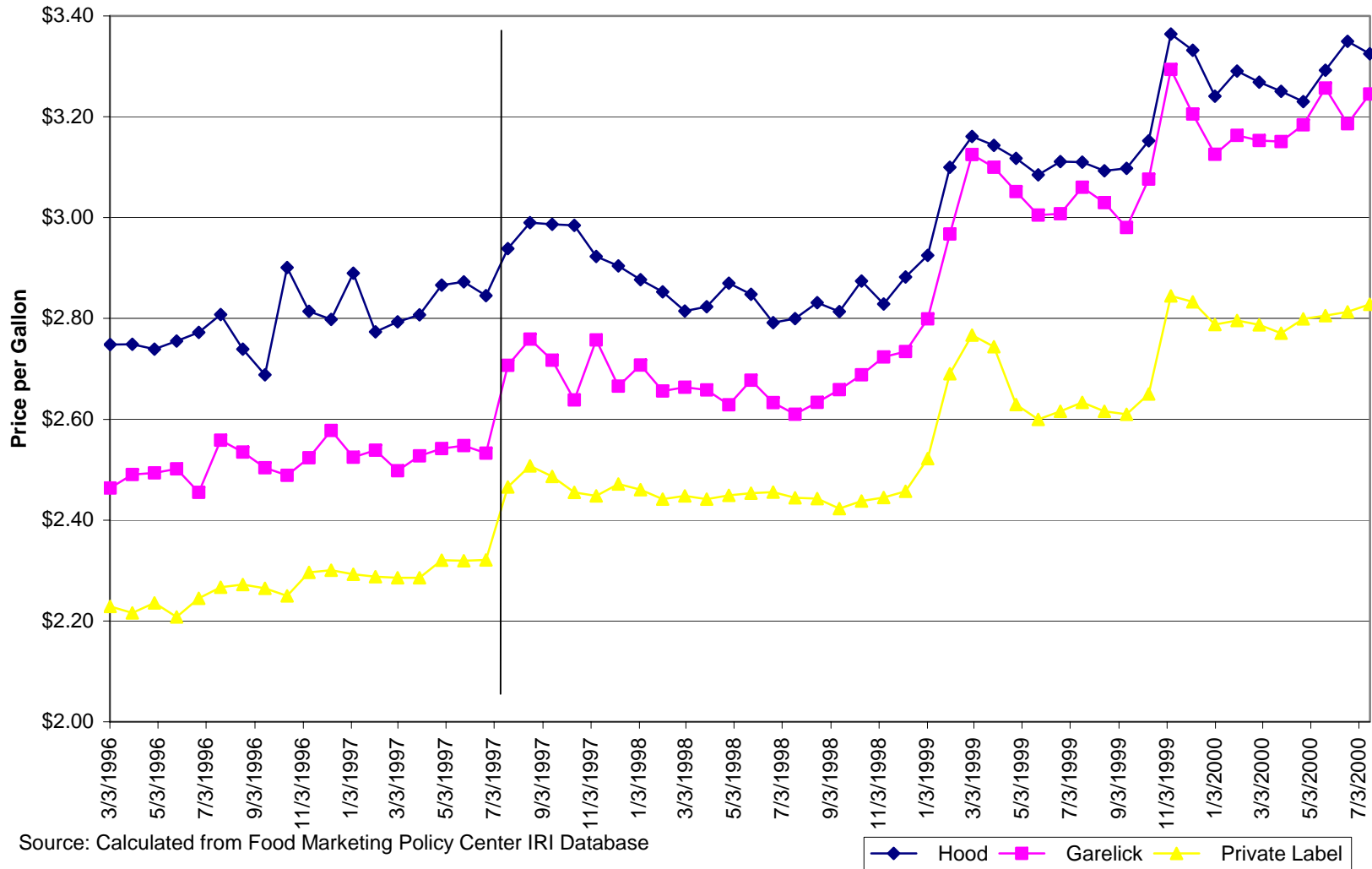
Providence  
Stop & Shop vs All Other Supermarkets  
Market Level Milk Price  
March 1996 - July 2000



Source: Calculated from Food Marketing Policy Center IRI database.

Figure 3.

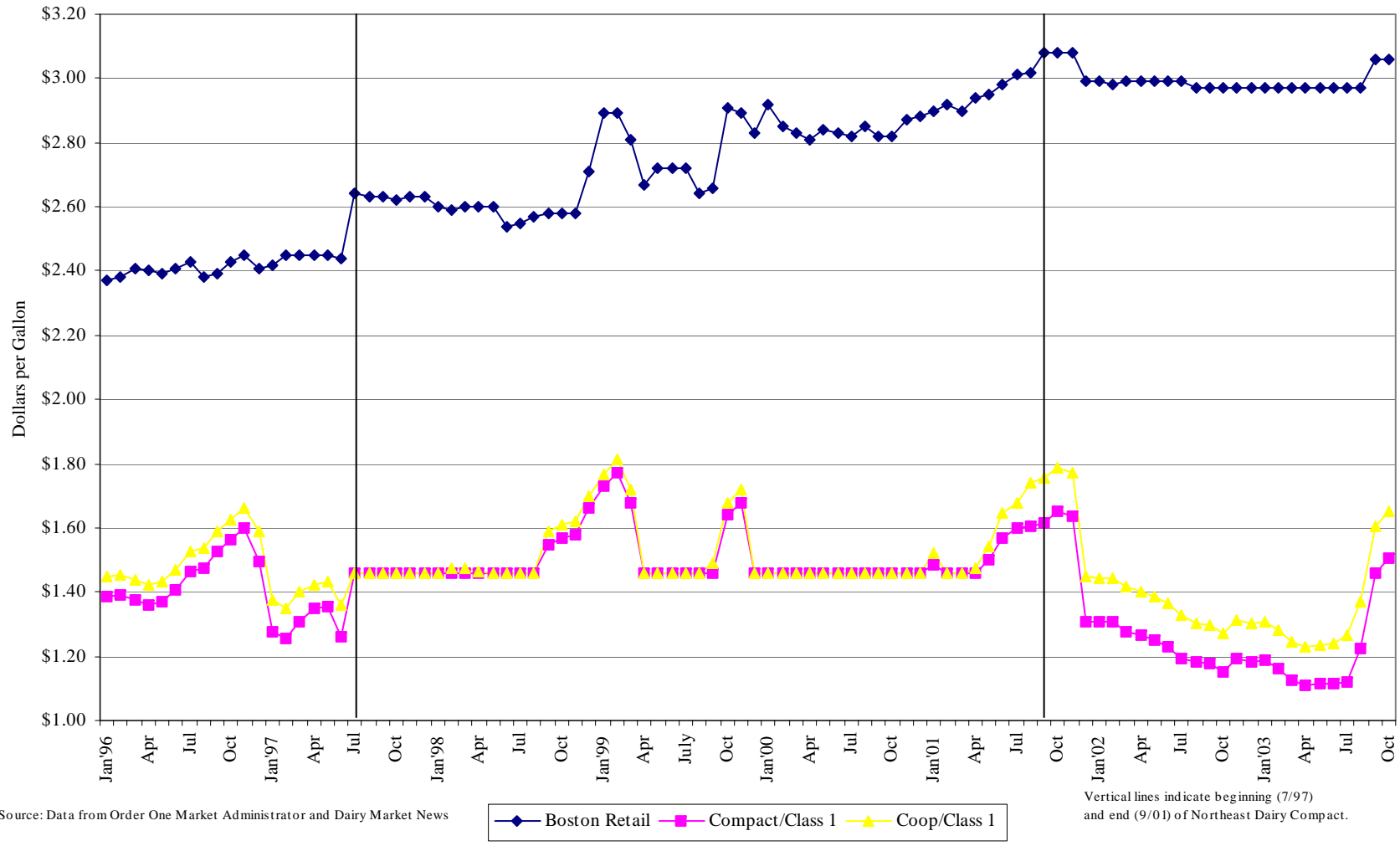
**Boston  
Brand Level Retail Milk Price  
March 1996 - July 2000**



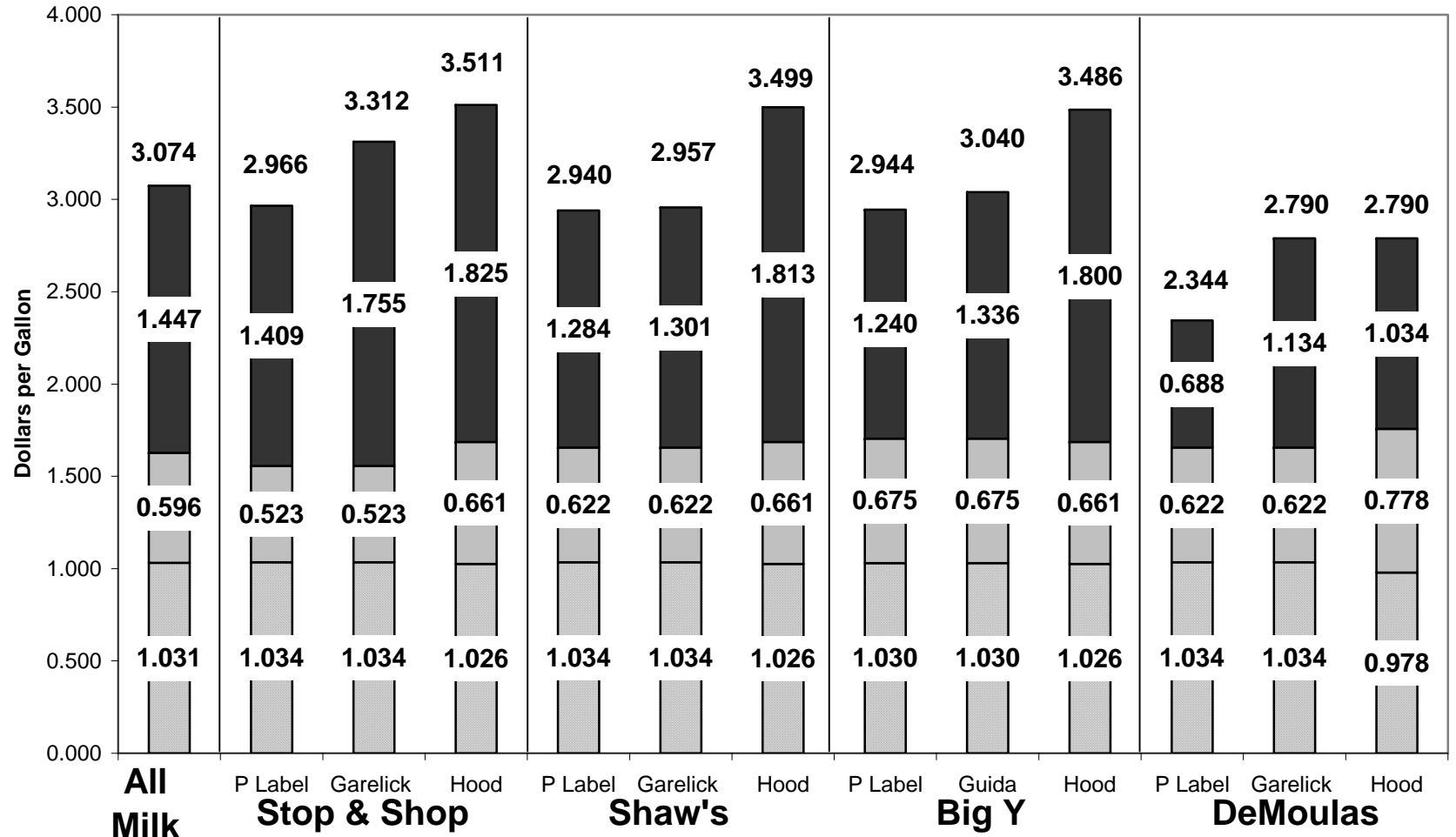
Source: Calculated from Food Marketing Policy Center IRI Database

Figure 4.

Boston  
Market Level Retail and Farm Fluid Milk Price  
January 1996 - October 2003



**Figure 5: Actual Raw Milk, Estimated Wholesale, and Actual Retail Milk Pricing by Brand for the Four Leading Supermarket Chains in Southern New England: June 2003**



Prices are the average across Whole, 2%, 1%, and Skim Milk and include all sales or promotional prices.

Raw Milk Price
  Wholesale \$ Margin
  Retail \$ Margin

# Appendix A

## Tables and Figures

Appendix Table 1: Hartford and Boston Retail Milk Prices and Raw Fluid Milk Prices

January 1996 - October 2003					
	Hartford Class I & Compact	Hartford Retail Price	Boston Class I & Compact	Boston Retail Price	Boston Coop Price
	Per gallon	Per gallon	Per gallon	Per gallon	Per gallon
Jan'96	1.38	2.38	1.39	2.37	1.45
Feb	1.38	2.40	1.39	2.38	1.45
Mar	1.36	2.41	1.37	2.41	1.44
Apr	1.35	2.40	1.36	2.40	1.42
May	1.36	2.40	1.37	2.39	1.43
Jun	1.41	2.42	1.40	2.41	1.47
Jul	1.45	2.44	1.46	2.43	1.53
Aug	1.47	2.46	1.48	2.38	1.54
Sep	1.52	2.45	1.52	2.39	1.59
Oct	1.55	2.46	1.56	2.43	1.63
Nov	1.59	2.50	1.60	2.45	1.66
Dec	1.49	2.50	1.49	2.41	1.59
Jan'97	1.27	2.51	1.28	2.42	1.37
Feb	1.25	2.49	1.25	2.45	1.35
Mar	1.30	2.49	1.31	2.45	1.40
Apr	1.34	2.49	1.35	2.45	1.42
May	1.34	2.49	1.35	2.45	1.43
Jun	1.25	2.49	1.26	2.44	1.36
Jul	1.46	2.68	1.46	2.64	1.46
Aug	1.46	2.68	1.46	2.63	1.46
Sep	1.46	2.68	1.46	2.63	1.46
Oct	1.46	2.68	1.46	2.62	1.46
Nov	1.46	2.68	1.46	2.63	1.46
Dec	1.46	2.68	1.46	2.63	1.46
Jan'98	1.46	2.68	1.46	2.60	1.46
Feb	1.46	2.68	1.46	2.59	1.48
Mar	1.46	2.68	1.46	2.60	1.47
Apr	1.46	2.69	1.46	2.60	1.47
May	1.46	2.68	1.46	2.60	1.46
Jun	1.46	2.61	1.46	2.54	1.46
Jul	1.46	2.60	1.46	2.55	1.46
Aug	1.46	2.60	1.46	2.57	1.46
Sept	1.54	2.61	1.55	2.58	1.59
Oct	1.56	2.64	1.57	2.58	1.61
Nov	1.57	2.66	1.58	2.58	1.62
Dec	1.65	2.74	1.66	2.71	1.70

(continues)

Appendix Table 1. (continued)

January 1996 - October 2003					
	Hartford Class I & Compact Per gallon	Hartford Retail Price Per gallon	Boston Class I & Compact Per gallon	Boston Retail Price Per gallon	Boston Coop Price Per gallon
Jan'99	1.72	2.89	1.73	2.89	1.77
Feb	1.76	2.89	1.77	2.89	1.81
Mar	1.67	2.88	1.68	2.81	1.72
Apr	1.46	2.73	1.46	2.67	1.46
May	1.46	2.67	1.46	2.72	1.46
June	1.46	2.68	1.46	2.72	1.46
July	1.46	2.64	1.46	2.72	1.46
August	1.46	2.63	1.46	2.64	1.46
Sept	1.46	2.70	1.46	2.66	1.49
Oct	1.63	2.87	1.64	2.91	1.68
Nov	1.67	2.95	1.68	2.89	1.72
Dec	1.46	2.91	1.46	2.83	1.46
Jan'00	1.46	2.91	1.46	2.92	1.46
Feb	1.46	2.84	1.46	2.85	1.46
Mar	1.46	2.81	1.46	2.83	1.46
Apr	1.46	2.79	1.46	2.81	1.46
May	1.46	2.82	1.46	2.84	1.46
Jun	1.46	2.83	1.46	2.83	1.46
Jul	1.46	2.85	1.46	2.82	1.46
August	1.46	2.84	1.46	2.85	1.46
Sept	1.46	2.83	1.46	2.82	1.46
Oct	1.46	2.83	1.46	2.82	1.46
Nov	1.46	2.87	1.46	2.87	1.46
Dec	1.46	2.94	1.46	2.88	1.46
Jan'01	1.47	2.87	1.48	2.90	1.52
Feb	1.46	2.94	1.46	2.92	1.46
Mar	1.46	2.90	1.46	2.90	1.46
Apr	1.46	2.96	1.46	2.94	1.48
May	1.49	2.98	1.50	2.95	1.54
Jun	1.56	2.98	1.57	2.98	1.65
Jul	1.59	3.01	1.60	3.01	1.68
August	1.60	3.00	1.60	3.02	1.74
Sept	1.61	3.06	1.62	3.08	1.76
Oct	1.64	3.07	1.65	3.08	1.79
Nov	1.63	3.10	1.63	3.08	1.77
Dec	1.30	3.00	1.31	2.99	1.45

(continues)

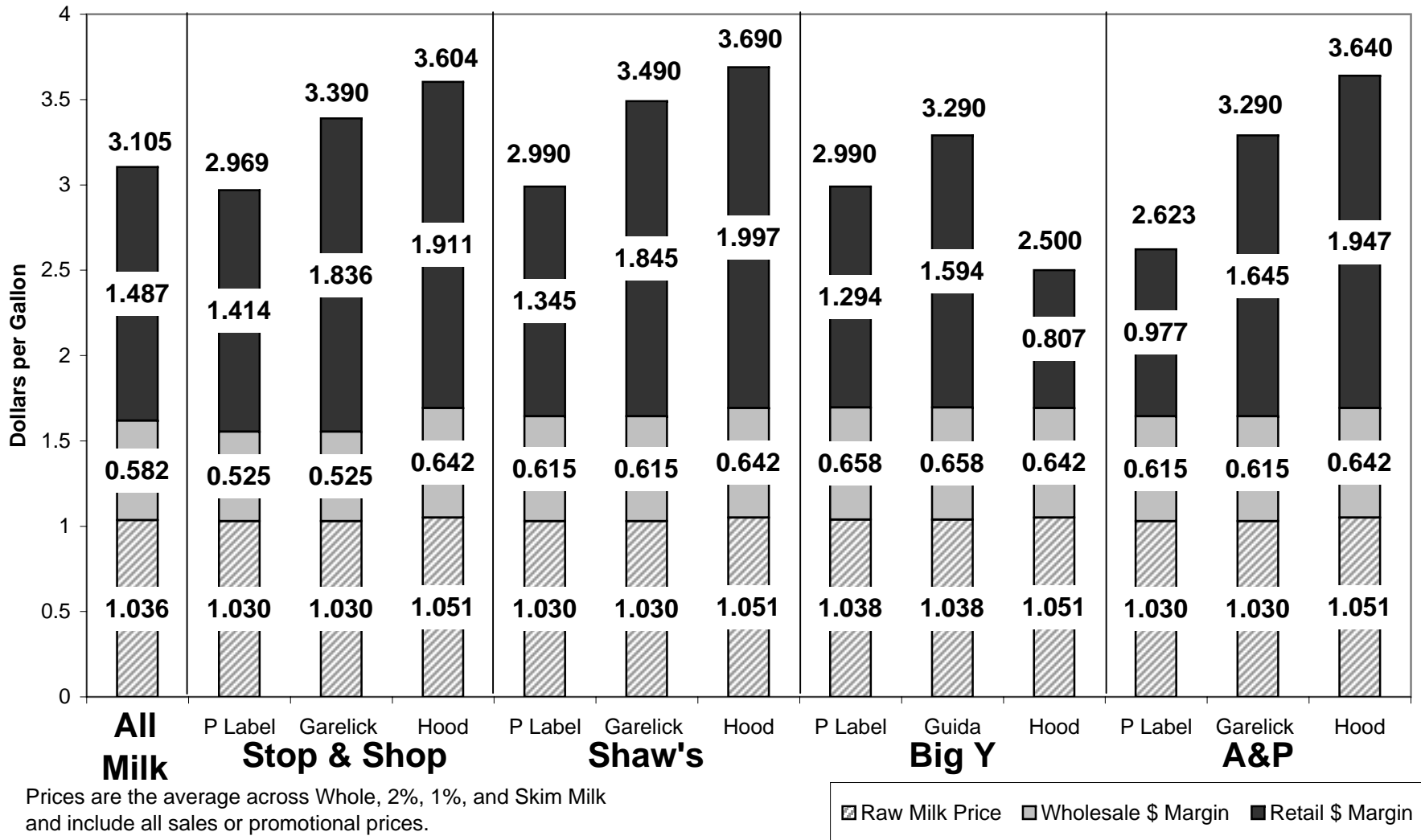
Appendix Table 1. (continued)

January 1996 - October 2003					
	Hartford Class I & Hartford Retail		Boston Class I & Compact Per gallon	Boston Retail	
	Compact Per gallon	Price Per gallon		Price Per gallon	Boston Coop Price Per gallon
Jan'02	1.30	3.01	1.31	2.99	1.45
Feb	1.30	3.00	1.31	2.98	1.44
Mar	1.27	3.00	1.28	2.99	1.42
Apr	1.26	2.99	1.27	2.99	1.40
May	1.24	2.99	1.25	2.99	1.39
Jun	1.22	2.99	1.23	2.99	1.37
Jul	1.18	2.99	1.19	2.99	1.33
August	1.17	2.99	1.18	2.97	1.30
Sept	1.17	2.99	1.18	2.97	1.30
Oct	1.14	2.99	1.15	2.97	1.27
Nov	1.18	2.99	1.19	2.97	1.31
Dec	1.18	2.99	1.18	2.97	1.30
Jan'03	1.18	2.99	1.19	2.97	1.31
Feb	1.15	2.99	1.16	2.97	1.28
Mar	1.11	2.99	1.12	2.97	1.24
Apr	1.10	2.99	1.11	2.97	1.23
May	1.11	2.99	1.11	2.97	1.23
Jun	1.11	2.99	1.12	2.97	1.24
Jul	1.11	3.02	1.12	2.97	1.27
Aug	1.21	3.02	1.22	2.97	1.37
Sept	1.45	3.07	1.46	3.06	1.60
Oct	1.50	3.10	1.51	3.06	1.65

Source: Data from Order One Market Administrator and Dairy Market News

Note: Northeast Dairy Compact began 7/97 and ended 9/01

**Appendix Figure 1: Actual Raw Milk, Estimated Wholesale, and Actual Retail Milk Pricing by Brand for the Four Leading Supermarket Chains in Southern New England: March 2003**



## Appendix B

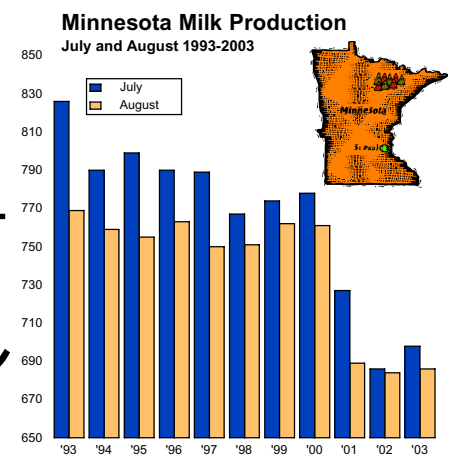
*Cheese Reporter* article, “Controversy Over Level Of Farm  
Versus Retail Milk Prices Continues”

and

A letter to the editor in response to the "Controversy Over  
Level Of Farm Versus Retail Milk Prices Continues”

# CHEESE REPORTER

Vol. 128, No. 12 • Friday, September 26, 2003 • Madison, Wisconsin



## Controversy Over Level Of Farm Versus Retail Milk Prices Continues

**Storrs, CT**—The controversy in New England continues over whether retail milk prices are too high compared to farm milk prices, and over possible legislative remedies to those price differences.

The University of Connecticut's Food Marketing Policy Center this week released a study that concludes that retail milk prices in New England are "much higher" than in New York, which has a milk price gouging law that establishes a maximum threshold retail milk price of 200 percent over the announced Class I milk price plus any over-order premiums paid to farmers.

But a report prepared for the Massachusetts Food Association contends that the UConn price analysis is "flawed," that retail milk price markups are "reasonable," and that proposed legislation in Connecticut and Massachusetts is "misguided" and "grossly interferes" with the marketing of fluid milk.

The new UConn study was written by Adam N. Rabinowitz, graduate research assistant, Matthew Schwane, undergraduate research assistant, and Ronald W. Cotterill, director, all with the Food Marketing

Policy Center. The study reports results for a retail milk price survey that was conducted in June 2003.

The survey found that, in nearly all cases, retail fluid milk prices in New York are lower than prices in New England for each type and channel, and the change over time is also different. For example, 2 percent milk in New York chain stores was \$2.25, down 10 cents from a survey conducted last November, while the same milk in New England was \$2.90, up five cents from last November.

Prices at convenience stores and chain supermarkets "are quite close," the survey found, while prices at club and limited-assortment stores "are much lower" In fact, club stores and limited-assortment stores were found to have "significantly cheaper milk prices in all geographic areas in this study."

One "significant change" from last November, the study noted, is that chain store prices in New York dropped about 10 cents across all types of milk, while there was no respective change in New England chain stores. The drop in New York prices was "due to the decrease in the

price threshold under the New York state price gouging law."

Last November, UConn had noted that Wal-Mart Supercenters were not the lowest priced chain in New England, "despite its reputation as a low-price leader in retail. This is no longer the case." The June survey found that Wal-Mart has come down in price in New England, and is the lowest priced chain in New York.

"It appears that Wal-Mart has listened to the press on high milk prices and has responded, reduced the gap between wholesale and retail prices, and now along with DeMoulas, prices milk in an effectively competitive fashion," the study said.

In addition to duplicating its November survey in New York, UConn researchers also cooperated with the New York State Attorney general's office to collect data from 191 stores throughout the state. The survey found that convenience stores in New York sell the highest-priced milk in the state, ranging from an average lowest price of

• See **Retail vs. Farm Price**, p. 15

### MIF Opposes Hearing On Fluid Milk Definition, Wants Greater Knowledge Base On Milk-Based Drinks

**Washington**—Members of the Milk Industry Foundation (MIF) are opposing a recent request that the US Department of Agriculture (USDA) hold an emergency hearing to address the fluid milk product definition under federal milk marketing orders.

In comments filed with USDA last Friday, MIF also suggested that USDA delay action on this subject "to allow the industry to develop a greater knowledge base about new milk-based drinks and other beverages containing milk, and to understand the competitive relationship between traditional fluid milk products and those that contain smaller amounts of milk-derived components."

More specifically, MIF suggested a delay of one year "to allow adequate market experience to evaluate the competitive beverage market and to

• See **Fluid Milk Definition**, p. 6

### Domestic Commercial Sales Of Nonfat Dry Milk Hit 10-Year Low, As Does Dairy Use

**Elmhurst, IL**—Domestic commercial sales of nonfat dry milk (NDM) last year totaled 741.7 million pounds, down 19.4 percent, or 178.5 million pounds, from 2001 and the lowest level of domestic commercial NDM sales since 1993, according to a new report from the American Dairy Products Institute (ADPI).

Domestic commercial NDM sales were last below the 800-million-pound mark in 1993, when they totaled 591.0 million pounds. The highest level of domestic commercial NDM sales since then was 954.7 million pounds in 1995, while the highest level this decade was 920.2 million pounds in 2001, according to ADPI's "2002 Dry Milk Products Utilization & Production Trends," as well as previous ADPI reports.

This compilation represents the 55th annual industry-wide survey of end-uses. The census, participated in by ADPI members, other cooperating processors, and distributors, reflects approximately 85 percent of

total domestic distribution. With such comprehensive coverage, projections have been made from the survey data to the total industry.

The dairy industry is by far the largest domestic buyer of nonfat dry milk, and last year NDM sales to the dairy industry totaled 416.2 million pounds, down 33.0 percent, or 204.9 million pounds, from 2001. That was also the lowest level since 1993, when sales to the dairy industry totaled 378.2 million pounds.

Nonfat dry milk sales to the dairy industry had reached a high of 651.3 million pounds in 1998.

NDM sales to the dairy industry accounted for 56.1 percent of total domestic commercial sales of NDM last year, down from 67.5 percent of total domestic commercial sales in 2001. Prior to last year and going back to 1993, the dairy industry's share of total domestic commercial sales of NDM has ranged between

• See **NDM Sales Decline**, p. 8

### Use of rbST Found To Boost Output Per Cow, But Not Net Income Per Cow

**Ithaca, NY**—The use of recombinant bovine somatotropin (rbST) on New York dairy farms increased milk production per cow but did not translate into any increase in net income per cow, according to a new paper by Loren Tauer, professor in Cornell University's department of applied economics and management.

RbST, also known as bovine growth hormone (BGH), became commercially available to US dairy producers in February of 1994, following years of investigation and testing in the US, Tauer noted. RbST can be injected into the dairy cow to augment her naturally produced levels of this hormone, enhancing milk production, but also requiring additional feed and other inputs to achieve increased milk production.

Given the large production response per cow that most of the tests reported prior to rbST approval, the hormone was generally projected to be profitable for dairy farmers, with estimates often exceeding \$100 per year per cow, although some projected little or no profit, Tauer noted.

Although Monsanto's Posilac rbST product has been available for almost 10 years and a number of studies have estimated the determinants of rbST adoption, few studies have assessed actual profitability on dairy farms, he explained.

Tauer and W. A. Knoblauch used data from the same 259 New York dairy producers in 1993 and 1994 to estimate the impact of rbST on milk production per cow and return above variable cost per cow. The use of rbST had a positive and statistically significant impact on the change in average production per cow between the two years, but the profit change affect, although positive and large, was not statistically different from zero.

This new paper revisits the New York dairy farms for the production

• See **RbST Income Impact**, p. 20

#### INSIDE THIS ISSUE:

- 'Cancun Collapse Is Good News' p. 2
- Farms Face Opposition on Odors p. 3
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- Whey Solids Use Up in Food p. 9
- Licensed Cheese Imports Up p. 10

## Retail vs. Farm Price

(Continued from p. 1)

\$2.35 for 1 percent milk to \$2.67 for whole milk.

On the other hand, the survey found that wholesale clubs sell the least expensive milk, with averages always at or below \$1.97. The average lowest price for whole milk at chain stores was \$2.29, 51 cents cheaper than in New England.

"Even if one considers the average price of milk at chain stores at \$2.36, this is still significantly cheaper than the New England chain store average price, \$3.16 per gallon," the study noted.

Regarding compliance with New York's price threshold, the UConn analysis indicated that when the threshold price decreases substantially, as was the case from November to June, "compliance decreases as well."

UConn researchers also assisted Deborah Robinson, an intern with WashPIRG, in surveying Seattle area supermarkets and convenience stores in June 2003. The survey found that milk prices are higher in the Seattle area than in New England.

"Retail milk pricing is very non-competitive in Seattle and the big chains lead the way," the study said. The "fringe competitors" use milk as a loss leader to attract business, but "so few consumers actually switch that the high milk prices remain profitable for the leading chains."

### Consumers, Farmers Losing Out

"Lack of competition is driving retail milk prices in New England to record levels, despite some of the lowest farm prices in years," the UConn study said. "The impact of this is extensive, and is felt by both farmers and consumers."

Using a documented cost of 58.2 cents per gallon of milk for processing and delivering milk to retail outlets in April 2003, UConn researchers estimated that the wholesale price for milk delivered to the store in June, with a \$1.11 Class I price, was \$1.69 per gallon. Retail prices in New England continue to hover above \$3.00 per gallon.

"Clearly, it does not cost supermarkets \$1.31 a gallon for in-store handling, storing, and selling of milk," the study said. "It is clear that consumers lost out on the low farm prices from December 2001 to September 2003, while dairy farmers continued to suffer dire economic times."

While it appears that the New York price gouging law is effective in helping keep milk prices low, "there are obviously other forces in New York that play a factor because many firms' low prices are well below the law's threshold," the study said. Further, the increased lack of compliance with New York's law at low farm milk prices "indicates that a more complex law may be necessary if and when New England states

attempt to control the unconscionably excessive pricing of fluid milk."

The bottom line is that it appears the New York law, however imperfect in concept and/or enforcement, "is working in at least one fundamental and important economic dimension. Retail milk prices in New York are closer to the cost of production and distribution than they are in New England when farm prices are low.

"The law seems to be making a major contribution to the allocative efficiency in the New York milk industry," the study continued. "However, it has done little to elevate farm prices, thereby not addressing the dairy farm crisis that the region faces."

### Milk Prices Are Not A Problem

The report prepared for the Massachusetts Food Association was written by agricultural economist. John Schnittker. The specifics of the report address the Connecticut and Massachusetts milk pricing proposals.

There are "significant differences" between the two proposals, the report noted. The Connecticut proposal limits wholesale and retail markups to 140 percent and 130 percent, respectively, while the Massachusetts proposal calls for a finding of "unconscionably excessive" pricing and possible legal action by the state if the retail price equals or exceeds 200 percent of the farm price.

But from a practical standpoint, the two proposals are "very similar," the report said, as "they attempt to artificially create a situation in which the processor or retailer cannot cover the cost of acquiring, processing, transporting and merchandising fluid milk. Processors and retailers are then placed in the untenable situation of either not covering their costs and losing money or increasing the price paid for fluid milk in an attempt to widen the allowable farm-retail spread."

The analysis and findings of Schnittker's report regarding the Connecticut proposed law apply directly to the Massachusetts proposal. The overall costs of producing, processing, and merchandising fluid milk would increase, and consumers would be at risk that grocery store milk prices would increase.

"There is little doubt under either proposal that the low-priced, discount milk now available at many non-grocery store locations would see significant price increases, eliminating the discount milk option now available to low-income consumers," the report said.

At face value, retail prices that equal or exceed 200 percent of the farm price "sound excessive and unjustified," the report stated. "But this approach to milk pricing is mistaken and simplistic as well as arbitrary and capricious.

"It omits any recognition of the cost involved in processing, trans-

porting and merchandising fluid milk in its journey from the farm to the grocery store," the report said. "It also ignores the fact that processors pay a premium over and above the Class I price for fluid milk and that dairy farmers also receive government payments to compensate them for the presently low fluid milk price."

For example, if the farm price for fluid milk is \$1.20 per gallon and processors pay an over-order premium of 12 cents per gallon, the cost to the processor is \$1.32 per gallon. Processor costs, which include the cost of the container, processing, and transportation to the retail store are conservatively around 85 cents a gallon, resulting in a delivered wholesale price of \$2.17 per gallon.

Merchandising costs at retail for a grocery store, which include labor, utilities, capital cost, as well as advertising and other costs are at least 45 cents per gallon, giving a conservative estimate of \$2.62 per gallon before overhead and profit are added on.

The Massachusetts law as written "would make it impossible for a retail grocery to cover store milk cost at current farm price levels, as the maximum price allowable before the threat of a finding of 'unconscionably excessive' is only \$2.40/gallon in our example while the grocery store costs are \$2.62/gallon," the report said.

As with the Connecticut proposal

there is an incentive to increase the price paid to the producer so that the farm-retail spread widens to allow processors and retailers to cover their cost, the report continued. The Massachusetts proposal "clearly places even more pressure than the Connecticut proposal on the retailer to increase his pay price so that he is able to cover the wholesale price, store merchandising cost and still allow for overhead and profit."


According to the report, if this legislation were enacted and retailers increased their price to processors with the understanding that the increase would be passed along to dairy farmers, "the effect would be to increase the total costs associated with producing, processing and retailing fluid milk.

This would be a threat to consumers as it would likely sharply increase the price of fluid milk now marketed at discount prices" at various outlets.


"Chain grocery stores would also be in the position to increase retail prices as long as they increased returns to producers, setting up the classic case of spiraling costs and reduced fluid milk consumption," the report added.

Given the "true cost" of producing, processing and merchandising fluid milk, the report said the proposal "is misguided and should be viewed as an uneconomic and inefficient method to deal with low milk prices at the farm level." •






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October 19, 2003

Dick Groves, Editor  
The Cheese Reporter  
2810 Crossroads Drive, Suite 3000  
Madison, WI 53718

Dear Dick:

Your story in the Cheese Reporter, September 26, 2003, titled, "Controversy Over Level Of Farm Versus Retail Milk Prices Continues" is an excellent analysis of our recently released price survey and the John Schnittker critique of our earlier April 23, 2003 report to the Ct legislature. John's report was a consultant study for the Mass Food Distributor's Association and was released at the Sept 4th hearing held by the Mass Legislature's Committee on the Environment and Agriculture. I also testified there with Secretary of State Galvin (please see our website <http://www.fmpe.uconn.edu> for that written testimony, John's report, my initial written response to it, and related Boston channel TV news videos. We are very pleased to be able to provide videos and radio pieces on line for viewing).

In this letter I will respond to Schnittker's main criticisms and comments on milk pricing, current milk price policies, and proposed milk price policies in the Northeast.

The proposed Mass price gouge law is the same as the current NY price gouge law that has been in effect for 12 years. JS incorrectly maintains that the 200% retail price collar applies to the class 1 fluid milk price. In fact in both the NY law and the proposed Mass

law the language is identical and very clear. The price collar is "when the retail price of fluid milk exceeds two hundred per cent of the farm price for class 1 fluid milk" (Mass bill, available on our website, NY law also there for comparison). The farm price for class 1 fluid milk is NOT the announced FMMO minimum price. It is that price plus any premiums paid to the farmer (both laws consider a cooperative that sells milk to a processor to be a "farmer"). Thus Schnittker's "current market" example loses its punch. He says the class 1 price is \$1.20 so the threshold price is \$2.40, but it is not because in his example there is a 12 cent per gallon over order premium. The threshold in fact is \$2.64, which is above his estimated costs of \$2.62 per gallon (farm price of \$1.32 +processors cost of 85 cents per gallon + retailers cost of 45 cents per gallon). Schnittker errs. The proposed law does not bind in the current market.

Moreover, Schnittker's calculation of the total channel cost of bottled milk is inflated. He does not recognize that the farm price in these laws is for 3.5% butterfat milk and bottled milk has at most 3.25% butterfat (whole milk). Most milk sold is 2%, 1% or skim milk. Processors sell the excess cream and the value of it should be subtracted from his estimated cost of \$2.62 per gallon. I estimate that the price reduction for sale of excess cream is approximately 17 cents per gallon so Schnittker's correct cost per gallon is  $\$2.62 - \$0.17 = \$2.45$ . This is very near to the price that De Moulas Supermarkets and Wal-Mart charged. ( See our most recent price study for June 2003) Note that Schnittker's total channel cost estimate, when corrected for sale of excess cream, is far below the retail prices charged by all other supermarket chains in New England. Those

prices are routinely above \$3.00 per gallon. Schnittker is silent on the discrepancy between his cost estimate and documented retail prices that are much higher.

The price gouge gap is even wider in this example. Schnittker's retailing cost is reasonably accurate, however his costs for processing and delivery into supermarkets are not. Dairy Technomics, a firm that is in the business of estimating processor costs to help supermarkets bargain for and monitor wholesale milk prices, finds that they are around 60 cents per gallon. Selected Dairy Tech estimates for Hood, Guida and Dean/Garelick milk, the big three processors, have been verified by the companies themselves or by an independent audit by Price Waterhouse (See my Preliminary Response to Schnittker on our web site)

In conclusion, when corrected for sale of excess cream and over estimation of processor costs Schnittker's "current market example", which appears to be for some month prior to the September 2003 run up in raw fluid milk prices, nicely illustrates that retail prices are unconscionably excessive because they generate gross profit margins far above wholesale delivered milk and in-store costs for retailers.

Schnittker also misses two critical points. First both the NY and the proposed Mass law give retailers an out. They can justify a retail price that is higher than the threshold price by documenting that it is due a high wholesale price paid to a processor and/or high in store costs such as labor or rent or utilities. If such costs account for a retail price above the threshold then the store is not in violation. These laws only go after excessive net of

cost profits at retail. Second, the price collar rate at 200% is not set in stone. It can be changed if it generates a large number of investigations that in fact are cost justified.

Schnittker incorrectly maintains that the NY and the proposed Mass law gives retailers incentives to pay higher wholesale prices with guidance that they be paid back to farmers as over order premiums so that the threshold price level will increase. Schnittker clearly contradicts himself here. In the above numerical example he maintained that the threshold price was only based on the class 1 price. Now he would correctly base it on the FMMO minimum class 1 price plus any over order premium. But Schnittker ignores the cost justification out that retailers have. If their costs are above the threshold all they must do is say so. They don't have to pay over order premiums to farmers to elevate the threshold. In the 12 years that the NY law has operated no retailer has ever even attempted to pay over order premiums for this reason.(See NY Ag and Markets Charles Huff's report on the operation of the NY law on our website)

This brings me to a basic and critical difference between the proposed Ct price collar approach the NY/Mass approach. The latter is a pro consumer approach that limits excess retail profits by lowering retail prices. Our pricing studies and Huff's review of the NY law demonstrate that this approach works. A little history is instructive here. In 1991 when the NY price gouge law was passed it was the consumer/downstate component of two bills that were linked for passage. Upstate rural interests wanted and received an over-order pricing law that empowered the NY Dept of Ag and Markets to elevate farm prices when they are extremely low as they were in 1990 and 1991 (and as they were

from Dec 2001 to Sept 2003). According to Huff the cooperation (logrolling) of farm and consumer interests (upstate and downstate interests) effectively ensured rapid passage of both bills. The problem, however came later when the over order pricing law was challenged in court and declared unconstitutional. Farmers lost their side of the policy solution to the low farm price and high consumer price milk problem.

Today the Connecticut proposal is an attempt to redress the farmer side of the milk price policy problem. Schnittker is correct when he says that the 140% price collar on processors will give processors incentive to raise farm price via payment of over order premiums if farm prices are so low that the 40% markup will not cover their costs. But this is true ONLY IF they want to avoid losses. Processors have a choice: either suffer right along with farmers when farm prices are low, or pay over order premiums until the collar no longer binds.

In the CT proposal retailers would be permitted to markup wholesale delivered prices only 130%. Given processors costs are approximately 60 cents per gallon the 140-% wholesale markup rule incents processors to pay over order premiums to raise the raw milk price for milk that actually goes in the bottles to \$1.50 per gallon (This is \$17.43 per cwt, and the payments to farmers for the excess cream up to 3.5% butterfat would add approximately another \$1.97 per cwt in our April 2003 example. The policy's parameters can be adjusted to target any desired level of farmer support). With raw bottling milk priced at \$1.50 per gallon the resulting wholesale price would be \$2.10 per gallon so the 130% retail rule allows retailers to price as high as \$2.73 per gallon. Note that this price

is well below current retail prices in New England (over \$3.00 per gallon). In conclusion, the CT approach raises farm price and lowers retail prices. BUT, retailers still get to keep 63 cents per gallon, an amount well above Schnittker's 45 cent retail cost per gallon. Most, but not all, of current retail profits are redistributed to farmers and consumers.

Schnittker fears that the CT proposal will set off a price spiral that will benefit farmers, processors and retailers at the expense of consumers. We too worried about this and carefully analyzed the post law equilibrium in Appendix D of our April 23,2003 report. Schnittker apparently failed to read it, for he never mentions it. There we demonstrate that the 130% retail price collar increases the effective store level own price elasticity of demand 4.33 times. This "flatter" effective demand really puts a damper on the price spiral hypothesis.. Stated otherwise, we demonstrate in Appendix D that for observed market values of retail and processing cost for input factors other than milk, profit maximizing retailers and processors will in fact behave as in the example given above. Farm price will increase and consumers will pay less.

Schnittker's concludes that the Cotterill proposal "is misguided and should be viewed as uneconomic and inefficient way to deal with low milk prices at the farm level".

We beg to differ. The CT price collar approach attacks demonstrated allocative (pricing) inefficiency in northeast milk marketing channels by bringing channel costs at each stage ( and especially the retailing stage) more in line with cost of production and distribution. As such it is an entirely new approach to milk policy, one that puts farmers in a

progressive position of promoting channel pricing efficiency rather than looking for a higher price at the farm gate devil-be-damned what happens downstream. For what happened downstream during the recent 21 month period of extremely low farm milk prices see Policy Issue Paper No 40 (on our website) or the report on it in the September 12, 2003 Cheese Reporter, p. 14. Public power via the market orders, according to an Iowa State study raises retail milk prices about \$1.50 per cwt, whereas our research documents that private market power exercised by retailers generates unconscionably excessive net profit rates and raises retail milk prices \$1.00 per gallon or \$11.60 per cwt. A policy that reigns in this excessive exercise of private market power in the milk channel can elevate farm fluid milk prices several dollars per cwt and still cut price to consumers. A farmer consumer alliance such as was achieved in New York in 1991 makes eminent sense for both groups.

Admittedly the CT price collar proposal could raise northeast farm level milk prices. IF the body politic wants to keep dairy farms in the region this is a policy that can help achieve that goal. During its 1997 to 2001 lifespan the Northeast Dairy Compact helped New England dairy farmers because it effectively restored what Congress wrote into federal market order legislation. Congress mandated a 16 cent per gallon or \$3.25 per cwt elevation of the class 1 minimum price for fluid milk at Boston relative to the upper Midwest. Except during the Compact era, recent farm mailbox prices in the northeast have been effectively equal to those received in the upper Midwest because farmers there have more bargaining power and have received significant over order premiums for their cheese milk as well as their fluid milk.

Now if one wishes to prevent the continued demise of dairy farms in the northeast, there is need for some other regional or state policies to once again elevate fluid prices in the northeast - a high cost of production area, but an area that is near densely populated urban areas that need fresh milk. (For more detail on this interregional milk pricing issue see FMPC Issue Paper No 37 on our website in the price gouging section. Also see the story on Ed Jesse's analysis by Ray Mueller in the Sept 12, 2003 Cheese Reporter. Ed recognizes that for some time now cheese milk premiums (and I would add class1 over order premiums necessitated by those cheese premiums to draw milk from cheese plants to bottling) have kept upper Midwest farm milk prices up. Jesse thinks it may be harder to do in the future but he and others are beavering away to find something. Give us Northeasterners the same license please.)

Sincerely,

Ronald W. Cotterill, Director  
Food Marketing Policy Center

## Appendix C

The Northeast Dairy Policy and Prices Summit Meeting  
A two-day Conference

November 17-18, 2003

To be held at

The University of Connecticut Storrs Campus  
Storrs, Connecticut



# University of Connecticut

## *College of Agriculture and Natural Resources*

October 20, 2003

We would like to invite you to a conference we are holding on November 17<sup>th</sup> and 18<sup>th</sup> at the University of Connecticut titled, “The Northeast Dairy Policy and Prices Summit.” The program is attached. Invited participants include key legislators, commissioners of agriculture, northeast dairy cooperative leaders, milk processors and retailers, and leaders of farm, environmental and consumer groups. Any interested person or industry participant is welcome at this meeting. We expect over 100 participants from New England, New York, Pennsylvania, New Jersey, and Delaware.

University of Connecticut research has documented extensive pricing problems in the New England fluid milk channel. Retail prices are far in excess of channel costs and farm prices are low due, in part, to a lack of bargaining power and consequently an inability to capture a larger portion of the consumers’ dollar. Farmers, fluid milk processors, and consumers are being short changed by powerful supermarket chains in New England. The story is entirely different and equally interesting in New York and Pennsylvania.

The goals of this meeting are: 1) to document current cost of production at the farm, processing, and retail levels in the milk distribution channel, 2) to explain current pricing practices in the farm to retail market channel, 3) to discuss current and proposed milk pricing policies at the state level, 4) to determine whether a coordinated regional effort can redirect pricing in the milk channel so that dairy farm income and/or consumer welfare are enhanced.

The future structure of dairy farming with its contribution to public environmental, open space, and cultural goals may very well depend upon the promulgation of pro-farmer policies at the state and regional level. Policies at the federal level will not be sufficient. This is partly due to the fact that cooperative and state/regional policies in other parts of the nation have offset federal initiatives that have recognized the higher value of fluid milk produced in the urbanized northeast.

A fundamental premise for this meeting is recognition that the Northeast, and especially New England, must consider state/regional action, as we did with the Northeast Dairy Compact between 1997 and 2000, to promote the future of the region’s dairy farming and

October 20, 2003

Page two

milk processing. We hope that you will join us. The attached information includes registration/lodging information. The cut off date for registration without a financial penalty is November 7<sup>th</sup>. Please R.S.V.P. to the following email address: [fmpe@uconn.edu](mailto:fmpe@uconn.edu).

Sincerely,

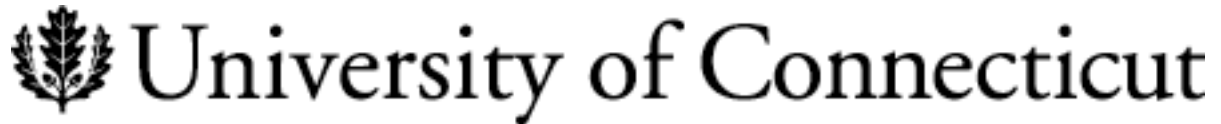
Ronald W. Cotterill, Director  
Food Marketing Policy Center  
University of Connecticut

For the conference organizing committee:  
George Wilber, Connecticut Representative  
Robert Wellington, Vice President and Economist, Agrimark Cooperative  
Ronald W. Cotterill, Director, Food Marketing Policy Center

RWC/lk  
Attachments

The conference information is also available on our website:

<http://www.fmpe.uconn.edu/dairysummit.pdf>



**The Northeast Dairy Policy and Prices Summit Meeting  
A two-day Conference**

**November 17-18, 2003**

**To be held at**

**The University of Connecticut Storrs Campus  
Storrs, Connecticut**

**Monday, November 17th at the Rome Ballroom in the Rome Commons**

**Tuesday, November 18th at Shippee Hall**

Meeting Sponsored by

The University of Connecticut  
College of Agriculture and Natural Resources,  
Cooperative Extension Service,  
The Food Marketing Policy Center, and  
The Council of State Governments, Northeast Section

# CONFERENCE PROGRAM

## Monday, November 17, 2003

9:00 – 9:45 a.m.	Registration, Coffee, and Snacks	
9:45 – 10:00 a.m.	Welcoming Remarks	George Wilber, Representative, Connecticut Legislature Carl Peterson, Chairman, Agri-Mark
10:00 a.m.	Cost of Production on Northeast Farms	Michael Sciabarassi, University of New Hampshire, Cooperative Extension
10:30 a.m.	Cost of Production on Large New York, New England Dairy Farms and Western Super Dairies	William Zwiegbaum, First Pioneer Farm Credit, Albany, New York
11:00 a.m.	Cost of Milk Processing and Distribution	Corey Durling, Partner Dairy Technomics, Lebanon, New Jersey
11:30	Retail in-store Costs of Milk Distribution	Professor George Criner, University of Maine
12:00 – 1:15 p.m.	Buffet Lunch – Rome Ballroom	
1:15 – 2:15 p.m.	The Outlook for Farm Milk Prices and Federal Dairy Policy	Robert Wellington, Economist, Agri-Mark, Lawrence, MA
2:15 – 3:15	Recent Retail, Wholesale, and Farm Prices in New England and New York: Documentation of Excessive Retail Margins in New England	Professor Ronald W. Cotterill, Director, Food Marketing Policy Center, University of Connecticut
3:15 – 3:30 p.m.	Coffee Break	
3:30 p.m.	State-Regional Policy Option 1. A Review of the New York Price Gouge Law	Charles Huff, Chief of Licensing/ Auditing, NY Department of Ag and Markets
4:30 – 5:30 p.m.	<b>Round Robin Forum:</b> Each organization or group can briefly introduce itself, and state its interests and/or concerns on dairy policy and pricing. The goal of this session is to facilitate discussion through the evening and on day two of the meeting.	
5:30 – 7:00 p.m.	Reception – Rome Ballroom	
7:00 – 9:30 p.m.	Dinner – Rome Ballroom	Keynote Speaker – Richard Blumenthal, Attorney General of Connecticut

**Tuesday, November 18, 2003**

9:00 a.m.	State-Regional Policy Option 2: Over Order Premiums by the Pennsylvania Milk Marketing Board	David DeSantis, Director, Enforcement and Accounting, Pennsylvania Milk Marketing Board
10:00 a.m.	Coffee Break	
10:15 – 11:15 a.m.	State-Regional Policy Option 3: The Proposed Connecticut Price Collar Approach	Professor Ronald W. Cotterill, Director, Food Marketing Policy Center, University of Connecticut
11:15 – 12:00 p.m.	Legal Aspects of State-Regional Policy Options	Douglas Eberly, General Counsel, Pennsylvania Milk Marketing Board
12:00 p.m.	Buffet Lunch – Pequot Room	
1:30 – 2:30 p.m.	Report from State Legislators on Status of Milk Price Regulation and Pending Legislation	
2:30 – 3:15 p.m.	Discussion of Policy Options to Promote the Viability of the Northeast Dairy Industry.	Facilitators: Representative George Wilber Carl Peterson, Chairman, Agri-Mark
3:15 – 3:30	Coffee Break	
3:30 – 4:00	Continued Discussion	
4:00 p.m.	Adjourn	

# REGISTRATION

Please complete this registration form and send it along with the \$75 registration fee to:

Dr. Ronald W. Cotterill, Director  
Food Marketing Policy Center  
Agricultural and Resource Economics  
1376 Storrs Road, Unit 4021  
Storrs, Connecticut 06269-4021

Checks are to be made payable to the **University of Connecticut**. We regret that cash and credit cards cannot be accepted.

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Organization .....

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City .....

State.....Zip Code.....

Telephone.....

Email .....

Fax.....

***REGISTRATION FORM AND CHECK MUST BE RECEIVED BY NOVEMBER 7<sup>TH</sup>***

***REGISTRATION FEE AFTER NOVEMBER 7<sup>TH</sup> WILL BE \$125***