

CHEESE REPORTER

Vol. 125, No. 43 • Friday, May 4, 2001 • Madison, Wisconsin



Milk Processors, Retailers Used Dairy Compact To Boost Profits: Study

Compact 'Seems To Have Facilitated Tacitly Collusive Pricing' By Processors, Retailers

Storrs, CT—Fluid milk processors and retailers “clearly used” the Northeast Interstate Dairy Compact implementation “to elevate and stabilize their margins,” a study released by the University of Connecticut this week concludes.

The study, written by Ronald W. Cotterill and Andrew W. Franklin of the university’s Food Marketing Policy Center, was designed to evaluate the Northeast Dairy Compact’s impact, the impact of marketing channel firms’ responses to the compact, and the impact of increasing concentration at the processor and retailer level on consumers, farmers, and firms in the market channel.

Since July 1997, the Northeast Dairy Compact Commission has set a minimum Class I milk price of \$16.94 per hundredweight, or \$1.46 per gallon. Processors have paid this price except for two short supply periods when the federal milk marketing order price moved above \$16.94 per hundredweight and fluid processors paid higher prices for raw milk.

“Our basic conclusion is that lead-

ing firms in the supermarket marketing channel have used, and continue to use, their dominant market positions to elevate retail milk prices well beyond levels justified by the Dairy Compact Commission,” the authors wrote in their study. “These higher prices and related consumer losses have been erroneously attributed by many observers to the compact’s operation and short supply conditions at the farm level.”

In response to the new study, Connecticut Attorney General Richard Blumenthal said he and attorneys general from other New England states, including Massachusetts, are planning legal action against retailers and dairy processors.

Cotterill and Franklin reached the following conclusions in their study:

• **Contrary to the economic theory of a competitive market, processor-retailer margins increased when farm-level fluid milk prices were stabilized by the Northeast Dairy Compact.**

The basic idea of asymmetric price transmission theory is that retail prices rise when farm prices rise, but

that retail prices do not drop as much when farm prices fall back to their original level. But for changes in other costs, firms prevent retail prices from dropping through the exercise of market power.

Therefore, if the compact eliminates farm price drops via its minimum price rule, it captures margin for the marketing channel firms. Due to asymmetric pricing, consumer prices do not decline if the compact does not exist, so the compact does not hurt consumers.

When the compact was implemented in July 1997, it raised the farm price six cents a gallon over its mean (average) price for the 18 preceding “before” compact observations. Processors paid on average six cents a gallon more for milk, but their input price risk was totally eliminated.

The marketing margin, or farm-to-retail spread, for all milk sold through supermarkets in Boston averaged 98 cents a gallon before the compact period, but the elimination of input price risk did not, as

• See **Profits Boosted**, p. 5

Bill To Extend, Expand Dairy Compacts Introduced; Coalition Voices Opposition

Washington—Bipartisan legislation reauthorizing the Northeast Dairy Compact, extending it to six more states and creating a Southern Dairy Compact was introduced in the House Wednesday.

The bill introduced by lead sponsors US Reps. Asa Hutchinson (R-AR) and Bob Etheridge (D-NC) would add five states — New York, Pennsylvania, New Jersey, Delaware and Maryland—to the six New England states that currently comprise the Northeast Dairy Compact.

Making up the proposed Southern Dairy Compact would be the states of Alabama, Arkansas, Georgia, Kansas, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, West Virginia and Virginia.

The Northeast Dairy Compact is scheduled to be terminated on September 30, unless it is extended by Congress.

Etheridge and Hutchinson said their bill has attracted more than 150 original co-sponsors to date.

“This bipartisan bill saves consumers money, protects dairy farmers, and gives states a voice in setting milk prices,” Hutchinson said.

“Passing this legislation is vital to the future of North Carolina dairy farmers and to the wallets of my constituents,” Etheridge commented. “The South is being flooded with milk, driving our farmers out of business and reducing competition. We are not going to stand by and do nothing while large corporate milk processors make a fortune by dumping surplus milk in our markets and forcing our dairy farmers to leave a business they love and enjoy.”

A day before the compact legislation was even introduced, more than 100 members of Congress sent a letter to House Speaker Dennis Hastert (R-IL) voicing their concerns and unified opposition to legislation authorizing the extension and expansion of dairy compacts.

• See **Compact Legislation**, p. 15

Initial NASS Estimates Understating Nonfat Dry Milk, Dry Whey Stocks, Overstating WPC Stocks

Washington—Initial government estimates of manufacturers’ nonfat dry milk stocks last year were an average of 28.6 million pounds below stock revisions published last week, a *Cheese Reporter* analysis shows.

For this analysis, *Cheese Reporter* compared initial figures for manufacturers’ end-of-month stocks of nonfat dry milk, as published by USDA’s National Agricultural Statistics Service (NASS) in its monthly “Dairy Products” report, with revised figures published in “Dairy Products 2000 Summary,” which was released by NASS last week.

For these reports, manufacturers’ stocks are defined as those product stocks held by manufacturers at all points and in transit. Last year, NASS noted, there were 1,124 manufacturers in the US that made one

• See **Understating Stocks**, p. 16

World Dairy Prices Expected To Rise In Coming Years, Buoyed By Strong Demand

Paris, France—Strong demand will lift world prices for all dairy products over the next five years, but skim milk powder demand will be held back by rising competition from whey powder and whole milk powder, a study released today concludes.

Agricultural markets are emerging from a prolonged period of downturn that has seen the value of many commodities reduced to historic lows, the new “Agricultural Outlook” by the Organization for Economic Cooperation and Development (OECD) noted.

World prices are expected to rise gradually to 2006, and more for some dairy products than for cereals and oilseeds.

Following are the report’s main projections for dairy products:

• Dairy production will rise three times as fast in non-OECD countries as within the OECD area.

• China will become a promising market for dairy exporters.

• Even if the dairy price support program in the US is extended beyond 2001, this is unlikely to alter the US medium-term competitiveness in export markets by very much.

• Further to the Australian dairy policy reform, that country’s dairy industry is expected to experience substantial structural change which should lead to greater production efficiencies and improved competitiveness.

Among the key issues identified in the report:

• A return of Russian demand for commercial cheese and butter imports to levels similar to those existing prior to the devaluation of the ruble in 1998 would affect the outlook.

• The risk of a return to unilateral protectionist action is still present, especially in the event of any serious economic crises, underscoring the importance of headway to be made in trade liberalization. •

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expected, decrease the margin after compact implementation.

To the contrary, the margin increased 12 cents per gallon to \$1.10 per gallon. Thus retail prices increased 18 cents, six cents to cover the increase in average raw milk price and another 12 cents to widen the marketing margin.

“Marketing firms clearly used the compact implementation to elevate and stabilize their margins,” the study said. “Retail prices increased well beyond the level needed to cover increased farm level milk prices.”

The authors concluded that the impact of input risk reduction on marketing margins “is being swamped by another economic force.” The implementation of the compact “seems to have facilitated tacitly collusive pricing by processors and retailers.”

- **Investigation indicates no transmission of farm level price changes to the retail level in the before compact period, creating a serious resource allocation and farm income problem, and invalidating prior studies of the compact’s impact that rely upon farm-to-retail price transmission models.**

An examination of farm prices for fluid milk and the all-milk retail price for the Boston IRI market “confirms that there is absolutely no relationship between farm and retail prices,” the study said. “Farm price fluctuates widely about its \$1.40 per gallon average price over the 18 pre-compact periods, but price transmission from farm to retail is virtually non-existent. Retail prices march to a different drum and increase in a steady fashion throughout the period.”

- **Marketing channel firms used compact implementation to lock in wide margins.** Margins did not narrow in July 1997 as one would have expected based upon prior observed price conduct in this market and economic theory.

Hood and Garelick margins drifted down during the first compact price peg period (July 1997 through August 1998) but private label remained quite stable, the study said. When farm prices spiked starting in September 1998 and again a year later, margins temporarily narrowed but the trend in 1999 and 2000 “is clearly up in a very strong fashion.”

- **A dramatic shift in retail pricing strategy occurs at compact implementation and subsequently.** Just before implementation of the Northeast Dairy Compact the spread between the retail and farm price was historically “very wide,” the study said. In fact, it was wider than at any other time during the before-compact period because the farm price was in a deep trough.

This was the time to put a program such as the compact into effect, the study continued. “Farmers clearly needed price relief and marketing firms had such fat margins that they could absorb an over-order premium without elevating retail prices.”

But in July 1997 retail milk prices in Boston went up 18 cents a gallon in response to the farm price increase of six cents a gallon over the average price of the before-compact period.

“Marketing firm price conduct shifted dramatically at the time of compact implementation,” the study said. “Before the compact, retail prices moved slowly higher along a very stable linear trend. Then retail prices jerk to life in lock step with the commission’s move.”

After compact implementation retail prices stabilized at the new higher margin level for as long as farm prices remained pegged at the \$1.46 per gallon level. When farm prices moved above that level in September 1998 and again a year later, retail prices again responded to the increase.

When farm prices fell back to the compact minimum price, retail prices did drop, but not back to the level observed in the first price peg period.

- **Suiza's rise to dominance in New England fluid milk processing is related to rising Garelick and private label prices.** The gap between Hood and Garelick prices "dramatically" narrowed in 1999 and 2000 "due to very strong price increases in Garelick milk."

What underpinned this narrowing of the brand gap?

"It may be entirely due to changes in retail price conduct, not processor price conduct," the study said. "If we knew the wholesale prices for milk, we could definitely determine who widened the retail-farm margin; however we do not know them."

Available public information and the IRI data "nonetheless strongly suggest that Garelick wholesale price increases contributed to rising retail prices," the study said. "The same is true for private label milk supplied by Suiza/Garelick."

The market structure of milk processing in New England "collapsed during this period to a single dominant firm, Suiza Foods, with extensive private label processing and Garelick fresh milk brand," the study said. Suiza purchased Garelick in July 1997, purchased another leading New England milk processor, West Lynn Creameries, a year later, and in August 1998 purchased another leading processor, Cumberland Farms. 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.

Finally, on June 1, 2000, Suiza/Garelick commenced supplying private label milk as well as Garelick brand milk to Stop & Shop. Prior to that, Stop & Shop processed its own private label milk in addition to processing and distributing the Hood milk that it sold in its supermarkets. Moreover, Stop & Shop controlled the marketing, including pricing of Hood milk in its stores.

"This means that for Stop & Shop there is no question who raised prices on 80 percent of the milk that it sold," the study said. "Since the company is fully integrated and controls the Hood as well as private label lines, Stop & Shop is responsible for higher retail prices on private label and Hood milk. Suiza and/or Stop & Shop are responsible for the higher prices on Garelick milk, which accounts for nearly all of the remaining milk sold in Stop & Shop supermarkets."

The study gave an estimate of the market shares in all of New England for the leading milk processors for the year ending June 30, 2000. Before the Stop & Shop private label contract, Suiza/Garelick accounted for 44.8 percent of fluid milk sales to supermarkets, which 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 & Shop Hood milk from Hood's share.

After the June 2000 closing of the Stop & Shop plant, Suiza controlled 63.7 percent of the New England supermarket channel, the study continued. Since Hood's Stop & Shop volume "will undoubtedly drop under the new arrangement because Stop & Shop clearly has less incentive to sell Hood milk, this share is understated. We estimate that after the consummation of the Stop & Shop deal, Suiza/Garelick will sell more than four times the volume of milk that its nearest competitor, Hood, sells in New England."

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 & Shop acquisition," the study added.

"Given this very major increase in processor concentration in the New England market, we conclude that 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 as well as the exercising of marketing power by supermarket chains at the retail level," the study said.

"We also conclude that any scale, capacity utilization, or distribution economies that Suiza may have captured with its rise to dominance, have not been passed forward to consumers in the form of a lower retail-farm marketing margin and lower retail prices," the study added.

- **Increasing retail concentration and the dominance of Stop & Shop and Hannaford is related to rising milk prices.** Leading supermarket chains in the four New England markets have also achieved high levels of market concentration.

Stop & Shop is a dominant firm in Hartford/Springfield and Providence with market shares of 41.8 percent and 47.3 percent respectively. Hannaford Stop N Save is the leader and dominant in northern New England with a 36.7 percent market share and no close competitor.

- **Estimation of market and brand level elasticities documents that the exercise of market power is a source of wider margins and higher retail prices in the post compact period.**

Market power can be exercised in the channel by either processors, retailers, or both. Cotterill and Franklin concluded that Suiza and Stop & Shop are the key players in any market power game in southern New England markets.

“Emerging ‘strategic partnerships or strategic alliances’ between Suiza, leading retailers, very recently other processors, and Dairy Farmers of America are eliminating and/or foreclosing processing capacity,” the study said. “Barring entry or expansion by fringe processors, channel profits are improving. Any efficiency gains in this new system are not being passed forward to consumers via lower prices.”

- **In the supermarket channel in New England, estimated loss to consumers due to the Dairy Compact are \$19 million, and consumer losses due to the exercise of market power are \$49.9 million.**

“Our results clearly document that the leading retailers and processors did more than oppose the compact in the political arena,” the study said. “They have used their power in markets to elevate prices. They also have attributed higher retail market prices to farmers and the compact program.”

- **The Dairy Compact increased farm income \$128.5 million; but only \$51.5 million came from the supermarket channel and of that only \$19 million came from consumers with the rest coming from the compact’s price support feature.**

The impacts that this study reports, except for the exercise of market power by processors and retailers, are consistent with the rationale for the Northeast Dairy Compact. The exercise of market power in the marketing channel has distorted actual market performance to the benefit of processors and retailers at an expense to consumers that is “far greater” than the impact of the compact on consumers.

“This suggests that the major policy issue now facing New England consumers of fluid milk is not the Northeast Dairy Compact,” the study said.

- **Decomposing retail prices into payments for factors of production and profits documents how meager the compact’s contribution to higher prices is in comparison to the increase in profit by channel firms.**

The authors concluded that increased channel profits contributed as much to retail price increases as did the combination of the compact program and the sporadic strong raw milk market.

- **The exercise of market power by channel firms shifts the industry to a more elastic region of the fluid milk market demand curve, thereby reducing the effectiveness of the federal milk marketing order system and compacts.**

A fundamental law in economics is: profit maximizing firms will elevate price until quantity purchased is reduced to the level where demand for the product becomes elastic. Now with the increase in concentration and dominance in many local processing and food retailing markets, private firms are capturing the ability to price off the market demand curve.

As milk channel firms exercise market power to elevate prices and profits, inelastic demand becomes more elastic. As a result, the study said, the ability of public agencies to increase dairy farm income via classified pricing is reduced.

“If milk prices are elevated to the level where farm level market demand is elastic, then public classified pricing programs are completely ineffective,” the study continued. “An increase in farm price no longer increases farm revenue. It reduces farm revenue.”

If this is the future path for the US dairy industry, “it does not bode well for farmers or consumers,” the study concluded.