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**Vertical Foreclosure:
The Impact of the Proposed Reduction in
Diversion Limits on the Exercise of Market
Power and the Economic Performance
of Milk Marketing Channels in the
Mideast Federal Milk Marketing Area.**

by

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**Vertical Foreclosure:
The Impact of the Proposed Reduction in Diversion Limits on the
Exercise of Market Power and the Economic Performance of Milk
Marketing Channels in the Mideast Federal Milk Marketing Area.**

Statement of Ronald W. Cotterill*

Hearing to Amend Certain Provisions of the
Mideast Federal Milk Marketing Order (FMO33)

March 7-10, 2005
Wooster, Ohio

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INTRODUCTORY NOTE

This testimony is a critique of the DFA/Dean proposals to tighten pooling requirements. I did this for the country's largest milk broker, Ted Jacobi & Co. , St Louis, and a group of midwestern co-ops including Family Dairy Farms, the 4th largest co-op in the US (used to be called national Farmers Union milk co-op), and some small fluid processors and cheese companies in Order 33.

My reasoning is as follows. Basically DFA/Dean has the fluid market pretty much locked up via full supply contracts. By lowering the diversion limit, for example from 60% to 50%, milk marketers who have 250 lbs of milk to sell to the midwest must shift from selling 150 lbs manufacturing and 100 lbs fluid to 125 lbs each. For a cheese operator who needs the 150 for his plant he must up sales of fluid to 150 lbs. If he does not do his farmers do not qualify for the pool and blend price. Since DFA has the class fluid base pretty much locked up, these milk marketers must go to DFA and pay for the added class 1 base that they need to keep their farmers pooled.

Industry sources say that DFA often "sells" it to them for half of the producer price differential (the difference between the cheese price and the blend price). You might see Jeffrey Leeman's testimony at the same hearing on this point (available from John Vetne JohnVetne@verizon.net)

On cross examination the DFA attorney asked me how I knew and could say that some members of the DFA led marketing agency in common, especially smaller co-ops , and some small fluid processors that buy milk from the DFA system feel that they are discriminated against in favor of the dominant firms (DFA and Dean and DFA/Natl Dairy Holdings).

My answer was "Don't you know that they are part of the coalition that have engaged me to testify here? Why would they do so if they were happy with the DFA , Dean , NDH system?"

The lawyer sat down.

Note Exhibit 3 is the Wellington testimony on how Hood/NDH would have depooled Agri Mark. Exhibit 2 also discusses the possibility, not the certainty, that Big Y got price reductions last year. It is a very rational economic strategy. Even if it did not occur and it may not have , the world needs to know that such moves can occur when the structure of the channel is as noncompetitive as it is. Farmers are in a Ginger Bread boy position on the fox's head midstream.

Others in other parts of the country are very concerned about these types of power play.

I. Introduction

My name is Ronald Cotterill. I am a Professor of Agricultural and Resource Economics at the University of Connecticut, and Director of University of Connecticut's Food Marketing Policy Center. My curriculum vitae has been marked as Exhibit No. 1. I have been asked by John Vetne, attorney for White Eagle Milk Marketing Federation and other interested parties, to analyze the impact of proposed changes to pool qualification rules on pricing conduct and the economic performance of markets in Midwestern milk marketing channels. Proposal Number 2 at this Hearing would tighten pool performance standards by reducing the diversion limits for Sec 9c. cooperatives and other handlers from 60% to 50% in each of the months of August through February and from 70% to 60% in each of the months of March through July (Federal Register, 2/17/2005, p. 8045). Pool supply and cooperative plants would also experience a tightening of pooling standards, but the burden of these changes would fall more heavily on supply plants because supply plants qualify for pool participation on the merits of the individual plant's conduct while cooperative plants qualify by paper designation based on the cooperatives system-wide performance. Dean Foods has proposed additional, and more restrictive, pool qualification rules.

Milk cooperatives and proprietary handlers have expressed concern throughout the U.S. federal milk market order system about the impact of "paper pooling," and of depooling in response to nonfluid-use raw milk price volatility, on the stability, fairness, and logistical efficiency of the order system. In response to these concerns, USDA has entertained a series of proposals to tighten milk pool qualification standards in the federal milk marketing order system. Leading proponents of these changes are Dairy Farmers of America, (DFA) the nation's largest milk cooperative, and Dean Foods, the nation's largest fluid milk processor.

As I reviewed the hearings and arguments of parties leading up to this hearing, I have come to understand that “paper pooling” is an elusive concept. It is both an esoteric term of art unique to the federal milk order system, and a term of derision employed to describe someone else’s milk marketing practices. It always applies to milk used to make manufactured products produced by dairy farmers that participate in the federal order milk pool by paper designation of the reporting handler – usually a Section 9c cooperative association. However, only milk that is delivered to a pool distributing plant must be pooled. All other milk is pooled by paper designation, whether it is a paper reporting diverted milk, a paper designating a cooperative plant as a pool plant, or a paper agreement between a manufacturer and a cooperative in Order 33 allowing the Section 7e manufacturer’s plant to be pooled without plant-specific performance (i.e., shipments to distributors). I see no functional difference between milk that is diverted day after day to a nonpool cheese plant, and milk that is delivered day after day to Leprino’s 7e plant or a cooperative’s 7d plant. The 7d and 7e plants have a great advantage of form over substance, however. Milk delivered to those plants gets credit for producer “touch base” purposes, and does not count against the diversion limits of the cooperative. Therefore, I use “paper pooling” to refer to all milk that participates in the pool but is not delivered to a distributing plant. The objective of proposals in this hearing, and predecessor hearings, is to reduce the volume of milk that is pooled on paper for some but not all market participants. As discussed below, this would have the effect of foreclosing pool access to some milk, and enhance the value of “paper” held by those who remain on the pool.

Vetne (2005) and others, on behalf of several cooperatives with a minor share of regulated markets to the west, have criticized these proposed changes in prior hearings from the perspective of producer equity, the legislative intent of the 1937 Agricultural Marketing

Agreement Act that established market orders, the Nourse Commission (1962) study of market orders, and the relevant case law. The essence of that argument is that federal market orders are not intended to limit access of non-fluid use milk to a market order pool by non-economic means such as diversion limits. Even under market orders, transportation economics, plant location, and location of raw milk determine the farm gate value of milk (Vetne 2002b, , Black 1935, Cassels 1937, Pratt et al. 1998). All farmers are to share in the pooled value of milk sales across fluid and manufacturing classes of use on an equitable basis based upon the components of their milk and the location of their market or their customer's market.

To date there has been relatively little discussion in the hearings or post-hearing briefs about the impact of the proposed reductions in diversion limits upon the allocative efficiency of milk marketing channels. That is the issue I will address in this paper. Federal market orders were never intended to contribute to the monopolization of milk market channels either by cooperatives or proprietary firms or by such firms acting in concert, although orders have been used to create and maintain monopolies in the past (U.S. DOJ, 1977), and continue to provide powerful tools to stifle competition by increasing costs or reducing revenue for competitors.

The unique potential for federal milk order pooling rules to be used by a dominant cooperative to disadvantage a competitor was recently illustrated when DFA's National Dairy Holdings processing company proposed a merger with HP Hood in New England, with DFA or its designee to provide the full supply of milk to the merged Hood plants. If the merger had gone through as NDH/DFA intended, Agri-Mark cooperative would have lost its primary distributing plant outlet and therefore its primary source of federal order pooling base for member milk used to produce Cabot cheese and other manufactured products, as explained in testimony for the Senate Judiciary Committee by Robert Wellington, Agri-Mark's economist,

attached hereto as Exhibit 3. Faced with loss of pool access for much of its milk supply, Agri-Mark would probably have joined forces with DFA, as did its sister cooperatives, Dairylea and St. Albans, in the marketing agency in common, Dairy Marketing Services (DMS). This incident is an example of vertical foreclosure. The merger in the processing market created competitive problems in the milk assembly market.¹

At this hearing, as in prior proceedings, I submit that one of USDA's most important decision making functions in addressing "paper pooling issues" is to consider the competitive impact of proposed rules. If at all possible, USDA should avoid rule amendments that would contribute to the acquisition or exercise of market power by dominant milk assembly cooperatives and dominant milk processors. Such firms may acquire market power through competition on the merits and/or economies of scale and scope; however, they should not acquire it via violation of antitrust law or by administrative fiat in a regulatory process such as this one.

II. Impact Analysis

I have read several post hearing briefs from the recent Central Market Order hearing (Vetne 2005a, Vetne 2005b, Beshore, English) and have read the factual documentation requested from the Mideast Market Administrator by the parties participating in this hearing (DFA/MMPA, White Eagle, Dean). In response to a request from Dairy Farmers of America (DFA) and Michigan Milk Producers Association (MMPA) and a request from White Eagle Federation et al. the Mideast Order Market Administrator completed an impact analysis of the proposed reduction in diversion limits for October 2004 (DFA/MMPA) and for all months of

¹ Hood allayed Agri-Mark's concerns by agreeing to continue to procure fluid from them after the merger. However, vertical foreclosure and its impacts on an independent cooperative such as Agri-Mark remains an issue. Read on and see Cotterill in attached Exhibit 2.

2003-2004 (White Eagle). Table 1 reproduces the quantitative impact analysis of the reduction in diversion limitations for October 2004.²

Table 1: Mideast Market Administrator's
Estimated Impact on PPD of 10 Percent Reduction in Diversion Limitations: October 2004

Pooled Pounds	Estimated Overdiverted Pounds @ 50% Limitation	Adjusted Pooled Pounds	Producer Price Differential		
			As Pooled	Adjusted	Change
1,545,776,665	63,800,000	1,481,976,665	\$0.73	\$0.75	\$0.02

Source: Mideast Market Administrator's Office, DFA/MMPA Request No. 21

The market pool was 1.545 billion pounds and the 10% reduction in diversion limits would have reduced that pool by 63.8 million pounds. This 4.1% reduction would increase the producer price differential (and “blend” or statistical uniform price) only 2 cents per hundredweight. This suggests that the policy change is trivial. Proponents should then be relatively unconcerned about this proposal. However, the projected 2 cent impact on producer prices ignores the competitive consequences of the proposed changes on the performance of raw milk assembly, fluid milk processing, and ultimately retail fluid milk markets. Proponent’s competitive benefit from their proposal, and corresponding disbenefit to competitors, is more profound than a 2-cent impact on the producer blend price.

Precise quantitative analysis of these competitive impacts is not possible because the necessary data are not currently in the public domain. I requested market share data for fluid bottlers and the handlers that supply them in the Mideast Market Area from the Market Administrator. Such information is confidential and unavailable from USDA sources for hearings such as this one. Industry sources, however, suggest that Dairy Farmers of America (DFA) and its partner cooperatives in Capper-Volstead sanctioned marketing-agencies-in-

² Depooling did not occur during October 2004 so this analysis is not affected by that issue.

common or cooperative federations dominate raw milk sales in the Mideast Order. These agencies are: (1) Dairy Marketing Services (“DMS”), a Section 9c cooperative federation dominated by DFA with fluid milk sales throughout the Mideast; (2) the Mideast Marketing Agency (MEMA), a combination of DFA/DMS, Foremost Farms, Land O’ Lakes, and NFO in the Mideast area other than Michigan, and (3) the Producer Equalization Committee (PEC) consisting primarily of DFA and Michigan Milk Producers Association (MMPA) for sales in the state of Michigan.. For example, in September 2004 the three largest cooperatives marketed 1.095 billion pounds of raw milk, fully 82% of the Mideast (Federal Order 33) milk pool (FMO Statistical Response to White Eagle Federation Request, this Hearing, Table 17). One of the top three is White Eagle Federation, with pooled milk of about 145 million pounds, as explained in testimony by Jeff Leeman, leaving DFA/DMS and MMPA with 950 million pounds. The remaining cooperatives pooled 154 million pounds. However, the testimony at this hearing reveals that of the remaining cooperatives on the handler list (Exhibit 6, Table 1), Dairylea, Foremost Farms, NFO, Prairie Farms, and Upstate all marketed their milk through one of the DFA/DMS-dominated agencies in common. Their reported 9(c) milk, therefore, should be added to the total of 950 million pounds of DFA/DMS/MMPA, bringing the pooled milk within the control of these dominant suppliers to about 82% of the market. Only Lanco and Steamburg cooperatives are not accounted for, and I understand that they pool a negligible volume of milk in Order 33.

At the fluid processing level, large consolidated processors dominate the fluid milk industry. These include: (1) Dean Foods, which has a long term strategic alliance (full supply contracts) with DFA, and operates 12 plants in the Mideast and processes an estimated 250-300 million pounds of milk per month at these plants, (2) National Dairy Holdings (2 plants) which is

50% owned by DFA, and (3) Kroger, the region's largest grocery retailer, with Mideast distributing plants and an estimated 120 million pounds of receipts per month. Kroger is also fully supplied by the DFA/DMS and MMPA or their marketing agencies in common.

Map-Tables 8a through 8e of Exhibits 7 and 11 show 41 pool distributing plants remaining in Order 33 and their locations. Twelve of the plants on the Market Administrator's list are very small, having an average of 2 million pounds per month of milk receipts. (White Eagle Requested Data, Table 1). DFA/DMS and its marketing agencies in common provide full supplies to about 23 of the remaining 29 large and very large Order 33 distributing plants according to testimony by witnesses at this hearing on March 8, 2005. The White Eagle Federation provides supplies milk to 4 distributing plants. The total receipts of milk by all distributing plants, in million pounds, were 637 during December 2003, 630 in May 2004, and 659 in December 2004, including 22 – 25 million pounds of "other source" (nonpool) bulk milk (Id. Table 3). Producer milk received at distributing plants during October 2004 was 610 million pounds. (Id. Table 7). These receipts represent the aggregate pooling base for all market participants.

The largest cooperatives, DFA/DMS and MMPA, and their agency in common partners have sufficient pooling base to be unaffected by the proposed 10 points reduction in the diversion limit, as I understand the testimony of Mr. Gallagher and Mr. Rasch. Yet if 63.8 million pounds of manufacturing milk to nonpool plants is cut out of the pool, the corresponding amount of distributing plant receipts affected is 127.6 million pounds of milk. Currently, 127.6 pounds of distributing plant receipts would allow $1.5 \times 127.6 = 191.4$ million pounds of manufacturing milk into the pool. As proposed, that same fluid milk base would allow only 127.6 million pounds of milk into the pool (assumes a reduction of the diversion limit from 60 to

50%, i.e. manufacturing milk pooled can only be 60% or post change 50% of the pool). This reduction in ability to pool milk makes it more costly for any supplier with a limited share of the fluid market to supply Mideast fluid plants. Since distributing plant receipts for the October 2004 pool was 610 million pounds, the proposed change in the diversion limit potentially affects $127.6/610 = 20.9\%$ of the fluid market. Note that this is just a bit more than the market share of small cooperatives and independent producers not represented by the DFA led marketing agencies ($100 - 82 = 18\%$). These are the suppliers who are targeted by proposal two and who will be short of pooling base to meet the proposed change.

Plants supplied by White Eagle will also be disadvantaged by the lowering of the diversion limits because the ability to pool diverted milk has value to the plant that provides pooling base and to the producers who negotiate to supply the plant and thereby gain pooling base. Producers that would supply the 68 million pounds of milk withdrawn from the pool under Proposal No. 2 are economically disadvantaged in a direct fashion. Moreover, farmers who are part of the DFA led supply system may be also be disadvantaged because of a reduction in competition for their raw milk, i.e. a reduction in milk marketing alternatives.

Let's address the impact on farmers first. Salop recently described a phenomenon that he labels "predatory overbuying" as follows:

Predatory overbuying consists of overbuying inputs as a predatory strategy to cause buyer-side competitors in the input market to exit from the market or permanently shrink their capacity in order to gain monopsony power in the input market (Salop, 2005).

The reduction in diversion limits is not necessarily predatory, but it may be employed as a predatory tool and has a similar impact on the buying structure of the raw milk assembly market in the Mideast milkshed. The DFA-led buying combinations in this market already are the

dominant buyers and the change in the rule limits the ability of other milk assemblers in the milkshed to compete for farmer's milk because it reduces their ability to qualify for the pool.

Now examining the impact on milk assemblers competition in the sale of milk to fluid bottlers in this market area, Salop describes a second consequence from an increase in buyers market power such as that arising from the proposed reduction in diversion limits.

Raising Rivals' Costs (RRC) overbuying consists of overbuying inputs as an exclusionary strategy to raise rivals' input costs and thereby gain market power in the output market (Salop, 2005)

The impact on milk assemblers of reducing the diversion limits is equivalent to overbuying. Assemblers that are not in the DFA sphere of influence have higher costs to qualify for the pool. This suggests that they must charge fluid bottlers higher prices. Consider the experience of Central Equity Cooperatives in the Central Marketing Order.

The absence of fluid milk marketing opportunities is illustrated by Central Equity Coop, whose producer-members are clustered near the intersection of Oklahoma, Missouri, and Kansas state boundaries. In order to pool its member milk, Central Equity sells milk to Wells Dairy in Iowa, about 400 miles away. This long distance hauling, obviously, would not take place if a closer distributing plant (or cooperative pool plant) were made available to Central Equity (Vetne, 2005b).

The primary strategic alternatives for cooperative assemblers such as Central Equity in the Central order and for White Eagle in the Mideast order are to merge with DFA or to affiliate with their agency-in common and pay for access to their dominant raw fluid supply system.

Fluid milk bottlers [distributors] who are not in the DFA sphere of influence also face these higher costs and their ability to compete in the packaged fluid milk market is reduced. Moreover, switching to the DFA led supply system may not be a viable alternative. This is true to the extent that the web of vertical strategic alliances favors the largest firms at each level of

the milk market channel. This insight also suggests that smaller fluid processors currently supplied by the DFA led system may not be receiving the same terms as larger processors.

Vertical strategic alliances between large milk cooperatives and the nation's largest fluid processors are often touted as enhancing logistic efficiency. If that is indeed the case then they should compete on the merits and not seek advantages by changing market order regulations. Again recall the estimated 2 cent per hundred weight advantage of this proposed 10% point change in the diversion limit. Clearly if the large coops and distributors want this change it must be more important to them than 2 cents.

There is another side to vertical strategic alliances that suggests it is. Vertical strategic alliances between milk cooperatives and fluid processors and between processors and leading supermarket retailers in many regions of the country lead to vertical foreclosure games that benefit the dominant partners at each stage of the system {Wellington, (attached Exhibit 3), Cotterill (Exhibit 2) Cotterill, et al., 2003, and Miyakawa, 2004}.

These foreclosure games are of two general types. The dominant players at each stage can use their power to benefit their vertical alliance partners by imposing costs on their partners' rivals -- for example DFA/DMS, MEMA and DFA/MMPA and PEC at the milk assembly stage in the Mideast Market Area, Dean Foods and NDH (DFA) at the fluid processing stage, and Kroger or other dominant supermarket chains at retail in local retail market areas. Processors can, for example, benefit dominant retailers by making only high cost milk available to would be retail competitors forcing them "out" of the retail market.

Alternatively, as we have seen in the New England Market Area, a system of vertical alliances can impose higher costs on rivals and implement a price leadership scheme at retail (Cotterill 2005, relevant sections attached here as Exhibit 2). The result is higher retail prices

that are shared by all key players in the channel. Smaller fluid processors and smaller retailers that have higher costs are not about to challenge the dominant firms' price leadership because these firms have the ability to discipline them in a price war or in the non-price dimension. Recall dominant firms have lower costs throughout the system due to their buying power (and if approved in this hearing due to regulatory impacts). As Wellington (Exhibit 3), Miyakawa 2004, and Cotterill (Exhibit 2) explain it is entirely possible that vertical foreclosure games can be played against farmers in raw milk markets.

DFA and its agencies-in-common most likely claim superior milk assembly efficiencies as the source of their competitive advantage.³ On their point, the Dairy Marketing Services (DMS) website states:

“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.” {<http://www.dairymarketingservices.com>}

It also, however, is entirely possible that their dominant position is based upon their vertical contracts, and their participation in vertical collusion schemes such as those contemplated and observed in New England milk markets.

In conclusion, I remain skeptical and would recommend that the Secretary not approve Proposal 2 until a more careful analysis of the competitive impact demonstrates that anti-competitive consequences -- upon nondominant and small business processors, upon the small cooperatives who assemble milk and small business farmers that supply them, and upon nondominant retailers and consumers -- do not offset the two cent per hundred weight advantage of this proposed change. If large milk assemblers and fluid processors are efficient in a spatial

³ See Cotterill (1989) for analysis of commodity bargaining cooperatives as opposed to efficiency driven integrated cooperatives.

milk economy why do they need this regulatory change to benefit them and the farmers that they serve? The answer, as implied in testimony by Mr. Gallagher, lies not in the benefit of a 2-cent gain to DFA/DMS members, but rather in the harm caused by the proposed rules to DFA competitors who stand to lose \$0.73 per hundredweight PPD on 63.8 million pounds of milk forced to exit the market if the proposals are adopted.

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EXHIBIT 1

March 2005

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ACADEMIC BACKGROUND

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Joint Ph.D. in Economics and Agricultural Economics	University of Wisconsin, 1977
M.A., Economics	University of Wisconsin, 1976
M.S., Agricultural Economics	University of Wisconsin, 1974
George C. Marshall Fellow (Economics)	University of Copenhagen, 1971-72
B.S., With Honors and Distinction, Agricultural Economics	Cornell University, 1970

AREAS OF SPECIALIZATION

Economics Major Field: Industrial Organization
Agricultural Economics Major Field: Marketing
Economics Minor Field: Quantitative Methods
Agricultural Economics Minor Field: Public Finance

ADMINISTRATIVE ASSIGNMENTS/EDITORIAL DUTIES

Editor, *Agribusiness* 1998 to present. <http://www.interscience.wiley.com/jpages/0742-4477>

Editor, NE-165 Working Paper Series, 1986 to 2002.

Editorial Board Member, *Journal of Supply Chain Management*, 1996 to present.

Director, Food Marketing Policy Center at the University of Connecticut: 1988 to present.

Executive Director, 1986 to 2002, NE-165 Private Strategies, Public Policies, and Food System Performance, an international research consortium (regional research project with participants from over 35 universities in U.S., Canada, UK, France, Italy, Turkey, Australia, Japan, USDA, FDA, EPA, GAO, and Agriculture Canada).

Chairman, NE-165 Private Strategies, Public Policies, and Food System Performance of the U. S. Food System, 1986 to 1989.

Director, Michigan State University Program for Consumer Food Cooperatives: 1981

[Remainder of pp. 2-23 of Cotterill Curriculum Vita omitted. The full exhibit is available from the author, and will be posted with 2005 Mideast hearing exhibits on the USDA Dairy Programs website -- www.ams.usda.gov/dairy]

EXHIBIT 2

AN EXCERPT ON VERTICAL FORECLOSURE FROM

**Antitrust Analysis of Supermarket Retailing:
Common Global Concerns that Play Out in
Local Markets**

by

Ronald W. Cotterill

**An Invited Paper Delivered at the Australian Agricultural and Resource
Economics Association Annual Meeting**

Coffs Harbour

February 11, 2005

4. Vertical market power

The sequence of markets and industries between farmers and consumers, also has important implications for performance. As in the horizontal dimension the two primary dimensions of performance are efficiency and market power. Here, we retreat from the new Institutional Economics of contracts and focus squarely on open market pricing in a channel that has oligopostic manufacturing and retailing industries.

4.1. Vertical pricing games [DELETED]

4.2. Private label pricing strategy: competitive retailers [DELETED]

4.3. Countervailing or coalescing power

With his countervailing power hypotheses J. K. Galbraith posed a different solution to manufacturer power. He argued that the solution to power on one side of the market was to develop power to develop on the other side. The obvious examples of his time were labor unions that sought to countervail powerful large corporate employers, and agricultural bargaining cooperatives. In the resulting bilateral monopoly situation price and other terms of trade are indeterminant but for bargaining. Walter Adams and others, however, argued that concentration on both sides of a market would produce coalescing power, i.e. the adversaries would combine to affectively increase the exercise of power against others in markets up or down the market channel.

Dobson and Waterson analyze these two competing hypotheses for the *UK* supermarket industry. Their theoretical analysis begins with the premise that manufacturers and supermarkets

are locked in a bilateral monopoly situation in the wholesale market, i.e. countervailing power exists. They demonstrate that coalescing power is the outcome and consumers pay higher prices when supermarkets also have market power in the retail market (Dobson and Waterson, 1997 p. 428). Dobson and Waterson did not analyze the symmetric issue for the raw product market, however if manufacturers have buyer power there one would expect a symmetric result. Coalescing power between retailers and manufacturers would lower raw product prices to farmers.

4.4. Vertical market foreclosure and price leadership

There also is an important dynamic dimension to the exercise of market power in a vertical channel by retailers and manufacturers. The growth of supermarket chains to market dominance can reinforce anti-competitive conduct in the retail market via strategic moves in the vertical dimension. For example in *Toys R Us v. FTC*, 221F3d 928 (7th Circuit, 2000) the court found that this leading toy retailer was able to require toy manufacturers to offer less favorable terms of trade to other toy retailers, thereby hurting its rivals and reinforcing its market power at retail.

Consider a second vertical strategic game that may be more pernicious because it shares power gains with rival firms in the channel, and thus may more likely escape detection and persistently damage consumers. A dominant retail firm can extract cost concessions from a food processor that effectively force a dominant processor to charge other retailers higher wholesale prices. Yet now rather than use its cost advantage to start a price war at retail to damage competitors, the advantaged dominant retailer elevates prices so that competitors, whose costs are higher, make more not less profits than before. The dominant firm's price leadership

scheme, also increases its own profits and the profits of the processor profits (from higher priced sale to the retail fringe firms). The result is coalescing power against consumers.

This situation has existed in the New England fluid milk market since 2000 (Cotterill 2003 *et al.*) Royal Ahold via its Stop and Shop supermarket chain has had a dominant market share at retail (50 per cent) due primarily to horizontal mergers during the 1990's. In 2000 it closed its milk plant and negotiated a 20 year strategic alliance with the Dean Foods milk processing company that thereafter supplied over 80 per cent of New England supermarket milk.

In 2003 Stop and Shop paid the raw market price plus 53 cents per gallon for milk delivered into its stores. Competing supermarket chains pay 10 cents per gallon more for the same supply. Stop and Shop has led prices up so that retail margins over the past five years are \$1.50 per gallon. In store marginal costs are 20-25 cents per gallon and fully allocated costs are 40-50 cents per gallon. Therefore all supermarket chains are capturing approximately \$1 per gallon as a power premium and the processor earns a share as well. This vertical collusion game escapes Robinson-Patman prosecution in the U.S. because the cost discount granted to the powerful buyer does not damage other retailers.

Although not perfectly verified many market observers believe this coalescing power was also used against farmers. Big Y, a large regional supermarket chain that initially opted to receive its milk from the number three fluid processor recently threatened to switch to the dominant processor if it could not pay a lower wholesale price. The demand was so substantial that the processor went to its farmer cooperative supplier and demanded a lower raw milk price, otherwise it claimed it would lose the retail account and go out of business. Agri-Mark, the threatened regional co-op with annual sales of over \$500 million and over 1,400 members could not sell to Dean Foods because a competing national cooperative has a nationwide full supply

contract with that dominant processor. To keep their fluid market, in this situation, farmers in the regional cooperative cut price. This is positive proof that when it comes to the exercise of buyer power against farmers, the truth is often found in analysis of the institutional details in relevant antitrust markets rather than aggregate national analysis.

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**TESTIMONY TO THE UNITED STATES SENATE JUDICIARY
COMMITTEE
REGARDING THE COMPETITIVE ENVIRONMENT
FOR DAIRY AND LIVESTOCK PRODUCERS**

JULY 23, 2003

Introduction

My name is Robert D. Wellington and I serve as Senior Vice-President for Economics, Communications and Legislative Affairs for Agri-Mark Dairy Cooperative. Agri-Mark is a farmer-owned and controlled Capper-Volstead cooperative with approximately 1450 member dairy farms located throughout New York and the six New England states. We market about three billion pounds of farm milk annually. This represents slightly less than two percent of U.S. milk production.

Agri-Mark is extremely concerned about the changes in the competitive environment for its members' milk production. A decade ago, Agri-Mark could compete to sell its milk to any or all of more than a dozen major purchasers of fresh, Class I drinking milk. This would allow its member farms to fully share in the obligations and benefits of pooling milk under a Federal Milk Marketing Order. However, most of the Class I bottling plants in New England have been bought (and in several cases subsequently closed) by one handler, Suiza Foods. It has been estimated that they have more than 70% of the Class I market in New England alone. Suiza Foods, also the largest seller of Class I fresh drinking milk in the country, subsequently merged with Dean Foods, the second largest Class I seller. The resulting mega-company retained the name Dean Foods. Dean Foods currently has a full milk supply arrangement with Dairy Farmers of America.

Dairy Farmers of America (DFA)

Dairy Farmers of America ("DFA") is the result of the mergers of a number of large cooperatives, including Dairymen, Inc., Mid-America Dairymen, the Southern Region of Associated Milk Producers, Inc. and others. These constituent groups have a pedigree of antitrust violations dating back over sixty years.¹ Despite having been sued

¹ Reported decisions and decrees include:

United States v. Borden, 1940-1943 Trade Cas. (CCH) ¶ 56,062 (N.D. Ill. 1940);

United States of America v. Associated Milk Producers, Inc., 394 F. Supp. 29 (W.D. Mo. 1975);

United States v. Mid-America Dairymen, Inc., 1977-1 Trade Cas. (CCH) ¶ 61,508 (W.D. Mo. 1977);

United States v. Dairymen, Inc., 1983-2 Trade Cas. (CCH) ¶ 65,651 (W.D. Ky. 1983);

Alexander v. National Farmers' Organization, 645 F. Supp. 1146 (W.D. Mo. 1986).

repeatedly by the Department of Justice, various state agencies and private parties, and despite being subject to numerous permanent injunctions prohibiting predatory and anti-competitive behavior, DFA has persisted in flouting these injunctions and employing predatory tactics to gain a stranglehold on dairy production and producers throughout the Mid-West. DFA is probably the most blatant antitrust recidivist in the history of this country.

The First Proposed NDH/Hood Merger

Last fall, Agri-Mark's largest remaining customer, the H.P. Hood Company, announced that it was merging with National Dairy Holdings (NDH). NDH is owned and controlled by DFA. DFA was to have a full milk supply arrangement with the new Hood/NDH company. This would have left Agri-Mark with insufficient Class I sales to meet Federal Order Class I pooling requirements throughout the year and could have lowered the annual farm income of our members by more than \$50 million dollars. Agri-Mark's average size member farm would have lost about \$30,000 annually if it was not sharing in the Federal Order pool. As has happened in the past, Agri-Mark and/or its members likely would have been forced to join or affiliate with DFA.

We protested this proposed transaction to the Department of Justice. The concern we expressed was that DFA, which is far and away the largest dairy cooperative in the United States, intended to use this transaction to increase its market share at the expense of independent dairy producers, including Agri-Mark. We described DFA's history of predatory conduct, and demonstrated that the proposed merger was merely one more step – different in scope but not in kind – in DFA's pattern of driving out competing milk cooperatives and independent producers.

We also pointed to the experience of small cooperatives and independent producers who formerly supplied plants acquired by DFA, Dean or NDH in Nashville, Somerset (Kentucky), Idaho, New England, Dairylea in New York, and St. Alban's in New England. These cooperatives were given a Hobson's choice – market through DFA to your former customer or cease dairy operations – *after* being acquired by DFA. Most recently, on May 1, 2003, DFA struck again. Its affiliate, Lone Star, displaced the independent producers who had historically supplied Mid-States Dairy in St. Louis. Mid-States "encouraged" the displaced producers to join DFA's affiliate or lose their market.

The "New And Improved" NDH/Hood/DFA Transaction

In late April of this year, we received reports that the NDH/Hood deal had been abandoned. At the same time, however, DFA announced that it intended to "restructure" the NDH/Hood transaction as an exchange in stock and CEOs (in effect, a "virtual merger") and go forward with it. On May 13, 2003, the press reported that the parties intended to consummate the deal, albeit in a slightly altered form.

The NDH/Hood/DFA Transaction May Be Different, But It's No Better

Rumors in the industry have suggested that the “new” NDH/Hood/DFA deal may have been structured to make it non-reportable for Hart-Scott-Rodino purposes. Obviously, DFA cynically believes that it can thumb its nose at the Antitrust Division and “slam” this deal through with only some cosmetic changes. *This cannot be permitted to happen.* The proposed restructuring of the deal may be a more subtle tactic than the originally-proposed merger, but it will be no less harmful to DFA’s competitors. All the statements by the principals involved, including the principal architect of the transaction, Gary Hanman, CEO of DFA, indicate that they will accomplish the very same goals sought by the originally-proposed merger.

The DFA press release did not refer to any supply arrangements, as part of the transaction or otherwise, except for these two comments:

1. There was a brief and unexplained statement that Agri-Mark would not be (immediately?) displaced as a supplier to Hood; and
2. It was indicated that DFA would become the new supplier to the Hood plant at Winchester, Virginia.

However, Agri-Mark has heard in the field that Land O’Lakes (“LOL”) has been offered a deal by DFA: If LOL agreed to join DMS – a marketing agency in the Northeast controlled by DFA – DFA would not take over the supply at the Hood-Winchester plant in Virginia but would permit LOL to continue its historical supply arrangement at Winchester. Otherwise, DFA would, under the “restructured” transaction, oust LOL as supplier of the Hood plant at Winchester. LOL has now agreed to market through DMS.

It is plain that the contemplated three-way federation between and among DFA, NDH and Hood is inherently and inescapably fraught with anti-competitive dangers. As a result of the transaction, Hood, which is the prize DFA is pursuing,² will be 15% owned by DFA. This will represent a substantial degree of DFA control over Hood. Moreover, Hood in turn will acquire a 30% interest in NDH, thus becoming a co-venturer with DFA in NDH. There is no ambiguity as to what is going on here: DFA, NDH and Hood will be fused into a single, coordinated economic unit. To cement the relationship, Hood’s president and chief executive, John Kaneb, will become chairman and chief executive of NDH and NDH’s current president, Tracy Noll, will move over to become Hood’s president. In short, the proposed transaction is a “virtual merger” of DFA, NDH and

² Because DFA already controls NDH, it has no need to extend its control over NDH. We do not know the details of the transaction but we assume that Hood’s “minority investment” in NDH will likely take the form of a purchase of some of DFA’s interest in NDH, perhaps to help bail DFA out of the liquidity problems DFA has incurred in the course of its “buying up the world” campaign. If so, there will be no dilution of DFA’s control over NDH because post-transaction DFA will own 15% of Hood’s shares.

Hood. This virtual merger is consistent with DFA's pattern of predatory conduct, and should be aggressively investigated, regardless of its reportability under Hart-Scott-Rodino.

DFA's Use of Federal Order Rules to Achieve Monopoly

The anti-competitive effect of the proposed NDH/Hood/DFA transaction is magnified by DFA's history of exploiting monopoly-building opportunities under USDA's Federal Milk Order market access ("pooling") rules. A prime example of this exploitation can be seen in the recent regulatory "reform" of Milk Order rules and USDA's receptiveness to new regulatory limits on market access, limits fashioned and proposed by DFA, the largest cooperative constituent of USDA programs.

As described in the Justice Department's 1977 publication, *Milk Marketing* (a Report to the Task Group on Antitrust Immunities) at 292-393, many anti-competitive practices in the milk business are dependent upon the existence and structure of Federal Milk Marketing Orders. This continues to be true under USDA's new regulatory structure. The creation of larger federal milk markets no longer serves to preserve competition because the trend toward consolidation of processing plants and cooperatives severely limits market options for dairy farmers.

The most visible anti-competitive Milk Order practice in the 1970's was "pool loading" – use of Federal Order rules to load surplus milk onto the market of competitors for the purpose of depressing the pooled blend price to coerce non-member farmers to join the dominant cooperative. Current practices are less transparent, but no less effective, in their coercive result. Ironically, these practices are designed to "unload" milk of competitors from a pool. DFA's favored tactic has been to acquire the Class I processors in a market, thus capturing their attendant supply needs and as a result: (1) force competitors to shift to an alternative market with a lower blend price, (2) leave competitors with no access to a regulated federal market pool, or (3) require competitors to pay a market access tribute to DFA for the "service" of associating milk with a federal milk pool, reducing non-member revenue while enhancing DFA revenue. In other words, the injury to independent cooperatives and producers is not confined to the lost sales to Class I customers; it also includes the independents' loss of the ability to pool their milk on Federal Orders because sales to Class I customers are the "gateway" to Federal Order pooling.

DFA's strategy of denying access to markets has been structured around this new USDA regulatory environment. Federal Order market access is governed by pool qualification rules, which entitle dairy farmers to a revenue stream above the surplus (Class III) price in the form of a "Producer Price Differential" ("PPD"). Pool qualification entitles the dairy farmer (or his cooperative) to market milk and draw the PPD on a volume of milk equal to the volume of distributing (Class I fluid milk) plant sales, *times a multiple*. In section 1032.13 of the Central Market, for example, the

multiple is five -- i.e., for each hundredweight of milk sold to a Class I fluid milk plant, 500 pounds of milk may be pooled and draw the PPD. The right to an enhanced revenue stream to the holder of pool qualification thus has clear economic value. Market access gained by milk supply to fluid distributing plants also has, by its function of denying pooling and participation in the PPD, negative or exclusionary effects on competitors.

In the Northeast, there is currently no absolute limit, but proposals are pending and likely to be adopted (with the urging of DFA and allies) to limit pooled milk to a multiple of 5 (i.e., 80% of the milk supply may be diverted). Thus, DFA's acquisition of HP Hood or a supply contract for Hood's monthly distributing plant receipts of 60 million pounds (est. for 6 plants) will lock up 300 million pounds per month or 10 million pounds per day in pool access, and deny pooling opportunity for 300 million pounds per month of its competitors' milk.

DFA's Monopolizing of Local Milk Markets

It is crucial to dairy farmers to have regular, committed and nearby outlets for the milk they produce on their farm. Farm milk is bulky and highly perishable and is picked up at farms either every day or every other day. That milk must find a market immediately as it can not be stored in its raw form for more than a day or two; moreover the milk tanker itself is needed to pick up the next load of milk either that same day or the next. Agri-Mark members produce a 50,000-pound trailer load of milk every nine minutes of every day, 365 days a year. This includes weekends and holidays too.

In addition to its merger tactics and manipulation of the Federal Order system, DFA simply used its economic muscle to buy up market outlets for milk even though it does not have the local milk supply to service that milk. If need be, they transport milk into their new customer at great expense while local farmers struggle with what to do with their own milk. Usually, local farmers quickly recognize that they have no choice but to capitulate to and join DFA in order to have a market for their milk. DFA effectively removes both competition and choice for these producers. Instead of gaining membership through farmer choice as we and most other cooperatives do, DFA gains it by eliminating choice. We believe this is wrong for farmers, cooperatives and the marketplace.

Farmers have the opportunity to market their milk together through cooperatives under the Capper-Volstead Act. Cooperatives can also work together to jointly market milk under that Act. We strongly support the ability of farmers and cooperatives to do so and have done so ourselves. However we also believe it should be a choice for both farmers and their cooperatives to work together. It should not be forced upon them though the elimination of choice and competition as has often been the case involving DFA. Agri-Mark believes that cooperation amongst farmers and their cooperatives can benefit farmers but farmers must also have competition for their milk at the farm level. One large milk buying entity, be it cooperative or private company, invariably forces

farmers to be strictly price takers for their milk and minimizes their income. It also allows that organization, even if it is a cooperative, to ignore the local needs of their members and transfer income from those farmers to other areas of the country where they are seeking to expand their influence and economic power.

Conclusion

In summary, Agri-Mark and its farmer-members believe that the elimination of competition for farm milk supplies is bad for farmers, consumers and the marketplace. This is particularly the case when companies such as Dean Foods obtain such a huge majority of the Class I marketplace in a region and cooperatives such as DFA effectively buy a near monopoly on the ability to supply Dean Foods as well as other Class I outlets. These activities are plainly anti-competitive and the appropriate law enforcement agencies should take the appropriate steps necessary to address these issues.