

**Author's Response to Kenneth Bailey's Review of
"The Public Interest and Private Economic Power:
A Case Study of the Northeast Dairy Compact"**

by

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The Executive Director of the Northeast Dairy Compact Commission requested that Dr. Kenneth Bailey, Associate Professor, Dept. of Agricultural Economics and Rural Sociology, Pennsylvania State University review our study. Dr. Bailey has posted his review on his website, which in fact is where we found it. Here we will respond to every sentence of that review, to every point that he raises, and to every opinion that he states. The public deserves no less. In fact we have written a 20-page paper in response to his comments (Cotterill and Franklin 2001b). It compares our approach to his in a study of the Dairy Compact dated July 2000. We also revise our work in response to his criticisms; however, our basic conclusions are, if anything, stronger. We would request that he add our website to his review so that the public can easily access our report and our responses to his review, as well as his review.

Bailey:

"I am more than willing to assist the Compact Commission with an unbiased assessment of this study".

Cotterill and Franklin Response:

He should let others decide whether his review is unbiased. As we document in this response, it is biased because much of it is inaccurate and false. In a recent paper Bailey summarizes our study saying, "Cotterill and Franklin also concluded that the Compact had no impact on retail milk prices (Bailey 2001, p. 2)." This is a biased and

* This report and others sited here are available on the following web sites: <http://www.are.uconn.edu/fmktc.html> and <http://www.aers.psu.edu/DairyOutlook/reports/NECompactStudy.htm>.

very wrong description of our study's conclusion. He knows very well that our study found that the Compact had a 4.5 cents per gallon impact on retail prices. See for example his review letter, page 2, where he quotes our "assumption/conclusion" of a 4.5 cent per gallon impact to criticize it (also page 10 of this response). We are at a loss to explain why he would misrepresent our work and ask that he correct this biased statement.

Bailey:

"In fact I also asked Professor James Dunn from Penn State to assist me in this review."

Cotterill and Franklin Response:

The Commission asked for Dr. Bailey's assessment. Only Kenneth Bailey signed this letter. Therefore its contents are the sole work product of Dr. Bailey.

Bailey:

"My overall observation is that Drs. Cotterill and Franklin devised an unorthodox methodology merely to prove their assumption that the Compact had little impact on retail milk prices in New England."

Cotterill and Franklin Response:

Dr. Bailey's "unorthodox methodology" label is simply not true. We explain why below and in the companion paper that we have written comparing our method with his. Our method is based upon well-established policy analytic procedures, careful analysis of the data, economic theory, and prior research by industrial organization economists and agricultural economists.

More fundamentally Dr. Bailey's assertion that we “assume the Compact has little effect and then prove that assumption” is false and reveals a lack of basic scientific competence. Bailey does not distinguish between a hypothesis derived from theory and an assumption that underlies that analysis. In science no one assumes that a condition exists and then proves its existence. If one assumes something exists, it exists and one does not have to prove it.

In science, one starts with premises or assumptions, then one uses logic to derive hypotheses and finally resorts to empirical research to test whether actual observed conduct rejects or sustains the hypothesis. That is the method in our report.

Bailey:

"Once this assumption was made they then concluded that the balance of the observed retail milk price increases was due to market power and "tacitly collusive pricing at the retail level."

Cotterill and Franklin Response:

Dr. Bailey claims that we attribute all of the observed retail price increase to the "little impact" of the Compact and "market power and tacitly collusive pricing at the retail level." This statement is simply wrong. Table 14 of the report decomposes the retail price increases that occurred after Compact implementation in July 1997. It compares average prices during the July 1997 to July 2000 period to the “before-Compact” retail price estimate in each of the four New England market areas and for all of New England. For each area we report the increase in retail price due to the Compact minimum price provision, the increase in retail price due to strong milk markets (farm price above the Compact minimum), the increase retail price due to increases in other

non-milk processing and distribution costs, and finally the increase due to the widening of the farm-to-retail margin due to market power and tacitly collusive pricing. These four subcomponents sum to the total observed change in retail price.

Bailey:

“This is a strongly worded study. My concern is that the data and methodology does (sic) not support the conclusions reached. In other words, I don't think the Agricultural Economics profession will support the conclusions Drs. Cotterill and Franklin reached regarding the retail impact of the Compact and his (sic) theories on tacit collusion.”

Cotterill and Franklin Response:

This study is no more strongly worded than many other policy studies that analyze market power issues. Moreover the strong words flow from and are based on the analysis. Bailey's conjecture about how the Agricultural Economics profession will respond is not a scientific criticism of our study. As such it has no place in this dialogue. We can only respond to substantive points that he raises.

Our analysis is comprehensive, based on the facts, the scientific method and valid application of economic theory. In conjunction with the Report, our responses to Bailey in this document and the attached paper comparing our method to his establish that this is the case.

We would add that our analysis of tacit collusion is based upon research in industrial organization economics, not agricultural economics. These two fields overlap in the agricultural marketing area. Our case study approach makes extensive use of

graphs, tables, and linear regression analysis. It is not a narrowly focused advanced statistical study, however, that does not invalidate its conclusions. The brand level approach to demand elasticity and market power measurement is not well known in agricultural economics. In the industrial organization economics and antitrust analysis area, it is well known and is an accepted method for analyzing market power. Work at the Food Marketing Policy Center at the University of Connecticut has pioneered research in this area. In 1994, we presented the first brand level elasticity measurement of market power in a federal court antitrust trial (Cotterill and Haller, 1997). Although the court rejected the approach as too novel, one year later, both the FTC and DOJ publicly embraced the approach and it has been their primary method for analysis of mergers among branded food products manufacturers since (Baker, 1996; Shapiro, 1995; Werden and Rozanski, 1994). Food Marketing Policy Center supported work includes Cotterill, 1994; Cotterill and Putsis, 2000 and 2001; Cotterill, Putsis and Dhar, 2000; two Harvard University Ph.D's, a Yale University Ph.D, a University of Paris Ph.D. and three University of Connecticut Ph.D's. Nevo, 2001, an article in *Econometrica*, is the most innovative of these efforts. The most recent Ph.D. by Tirtha Dhar, *Two-Stage Oligopoly Pricing with Differentiated Products: The Boston Fluid Milk Market* is a nested logit demand model for brands of milk at the supermarket chain level in Boston. It uses the same data as we do and is an advanced structural model that tests alternative oligopoly games at the processor and retailer level. The Compact is included in the model and the results are essentially the same as reported in our case study. Margins are significantly higher after the Compact in this demand structure with a flexible Leontief cost function to control for changes in other costs.

Now that we are past the introduction to Bailey's review lets move on to his specifics.

Bailey:

"First, Drs. Cotterill and Franklin assumed that the farm-to-retail margin for milk would decrease once the Compact was enforced. This was based on two assumptions 1) asymmetric price transmission and 2) input price risk reduction."

Cotterill and Franklin Response:

We assumed nothing of the sort. Again Bailey maligns our method by showing his ignorance of the scientific method. In Section II of our report we carefully explain how economists and agricultural economists have deduced two hypotheses from economic theory. Eight separate economic studies (Hahn et al. 1994, Turnovsky 1969, Brorsen et al. 1985, Holt 1993, Saleh 1990, Azzam 1991, Friedman and Savage 1948, and Haley and Schall 1973) and the Compact Commission Proposed Rules (appended as Appendix H to the study) are the basis for hypotheses of the impact of the Compact on dairy pricing. On page 4 of our report we state:

"To summarize, there are two economic hypotheses that predict the Compact will narrow the marketing margin thereby reducing, or possibly offsetting entirely, the farm level price increase. Asymmetric price transmission and input price risk reduction both predict lower margins. In the rest of this section we evaluate the risk reduction hypothesis. In the following section we examine the asymmetric pricing hypothesis." (Cotterill and Franklin, 2001a, p. 4-5).

Note that we are stating hypothesis, i.e. predictions from economic theory. We are not assuming these to be true. Our resort to the data allowed us to see if they are valid. In fact we find that this was not the case. The farm-to-retail margin widened after

Compact implementation. This means that consumer prices went up because the Compact increased the farm price and because the margins, i.e. the difference between the retail and farm price that the market channel firms capture, also widened (Cotterill and Franklin 2001, Section II, Tables 1a, 1b, 45-46). In his own study of the Compact's impact Bailey also finds that the farm-to-retail margin widens after the Compact (Bailey 2000, p. 17).

In our study we develop two new hypotheses for the expansion of the post Compact margin. Logically there are only two economic possibilities. Either market channel firm's costs for inputs other than milk increased and/or the market channel firms exercised market power to elevate prices above costs and increase net profits. We analyze both options, the latter one in great detail given that we have brand level data for the leading chains in all New England markets. We find that costs increases in other inputs explain 7 cents and market power explains 11 cents of the actual price increase (29 cents) for all of New England (Cotterill and Franklin 2001a, Table 14, p. 57).

Bailey:

"Let me deal with the second assumption. The authors state on p. 6 of their report that, "the standard deviation of the farm price fell from .102 prior to the Compact to zero after the Compact." Unfortunately this is not true. I measured the standard deviation for the farm price-equal to the Class 1 cost of milk plus coop premiums plus the Compact over-order obligations both before and after implementation of the Compact. I found it fell from 1.03 during the period January 1994 - June 1997 to .99 during the period July 1997 - December 2000. The point is Drs. Cotterill and Franklin were wrong to assume

that the Compact reduced the variation in the cost of class 1 milk to zero. Therefore their assumption that this reduction should translate into a tighter margin is also wrong."

Cotterill and Franklin Response:

This really is a red herring issue for our impact analysis because we never factored any margin reduction due to decreased risk in raw milk price fluctuations into our quantitative analysis. Nonetheless we will respond. Bailey is less than charitable in his comments on our analysis of risk. He and Lass et al. completely ignore the issue when in fact it is one of two targets for the Compact: raw milk price risk reduction, and farm income elevation. No economist would deny that putting a price floor in a market reduces risk from what it would otherwise be. If price volatility does not decline over time, then it is evidence that the Compact floor price was indeed very low. Bailey recently, after our work appeared, has conducted a new analysis that incorporates risk.

Bailey claims that our standard deviations, one for the 18 periods in our data set that are prior to the Compact (.109) and the other for the 15 periods immediately after the Compact (zero) are not true measures of the level of risk and that his from a different data set and two larger time periods are. Ultimately it is an empirical issue; however, our use of our risk level measurements to analyze pricing at Compact implementation is valid. We cite evidence that at Compact implementation all parties knew that the raw milk price would be stabilized, indeed pegged, at \$1.46 per gallon for several months after the Compact. In others words the standard deviation would be reduced to zero for several months. Here is the key passage,

“both processors and retailers knew that the farm price would remain constant at that level (the Compact Minimum price \$1.46 per gallon) into the near term

future. In its proposed rules the Compact Commission wrote on April 28, 1997: “The price established by this rule will be a certain one; Berthiaume suggests that the combined, federal Order and Compact Over-order price will not vary for the six month term of its duration. At least for the short-term duration of this price regulation, the uncertainty of price variability in the region's Class I market will have been significantly reduced if not eliminated. (Federal Register, 4/28/97, p. 23049).”¹

In fact the Class I farm price remained pegged at \$1.46 per gallon for 15 months. Thus at compact implementation market channel firms knew that for the near term future their input price risk was eliminated. According to accepted microeconomic theory, the price increase at Compact implementation in July 1997 could have been moderated and the margin lowered due to this elimination of near term risk.

Bailey:

“The authors made a rather strong observation that “there is absolutely no relationship between farm and retail prices” for milk. Therefore, they assumed by this statement that the Compact had little or no impact on retail milk prices. In the process they rejected a rather large body of economic literature that suggests there is in fact a very strong relationship between farm and retail milk prices. But this is an important point in this study since it justifies the next step.”

Cotterill and Franklin Response:

Our “rather strong observation” is not for all milk markets and for all time periods. It is for the February 1996 through June 1997 time period in New England, and it is soundly based on statistical analysis of the data. One can not blithely ignore the

¹ From Cotterill and Franklin, 2001a, page 9.

instant data and assert that a relationship exists because “a rather large body of literature suggest that there is a very strong relationship between farm and retail milk prices.” We are fully aware of that research but point out in our study that recently in many markets including milk (GAO study) contemporaneous farm-to-retail price transmission is weak or nonexistent. Cotterill and Brundage (2001) investigate five other local milk markets for the same time period as used in our New England study. They find very imperfect price transmission over time in 3 of the 5: Seattle, Chicago, and Dallas. The farm-to-retail price transmission hypothesis must be tested in every data set and if found lacking, be replaced by another model before analysis can proceed. Milk and retail food markets are changing and have changed dramatically over the past 10 years. Old studies and their methods are not infallible.

Bailey:

“Without a classic farm-to-retail model to rely on, the authors “created” an unorthodox methodology to evaluate the impact of the compact on retail milk prices. This methodology was supposed to use a “before and after” approach in analyzing the Compact. In fact, there was no comparison between the farm-to-retail margin before the Compact and after the Compact. Rather, an index was created. This index compared the trend in retail milk prices before the Compact to the retail price increase during one month in July 1997. Again, this is an unorthodox methodology that is clearly not supported by the Agricultural Economics literature.”

Cotterill and Franklin Response:

Bailey simply did not read our paper. Our method is not unorthodox. We examine prices and margins before and after the Compact. To substantiate this point we

have written another paper that squarely addresses this issue by comparing our method to his. In the end, as our paper shows, it is Bailey's method that is unorthodox.

Bailey is simply wrong when he states there is no comparison of margins before and after the Compact. The first tables in the report, Tables 1a 1b, and Appendix Tables J1 to J5 do precisely that. Tables 1a and 1b at the outset of our report play a prominent role in our analysis.

Bailey next claims, "an index was created." This is his terminology not ours. We created no index, and we never compared this fictitious index to the retail price increase during one month in July 1997 to evaluate the impact of the Compact on retail milk prices. To substantiate our point we did a word search on "index" and variations of the word (e.g. indices, indexing) and found that the word only appears in the study when we discuss the consumer or producer price index.

Bailey:

"The author's methodology depends critically on the assumption that the Compact elevated retail milk prices 6 cents per gallon in 30 of the 40 after-Compact periods, for an average increase of 4.5 cents per gallon. This assumption/conclusion was derived from an observation that the Class I farm price of milk (Class I price plus Compact premium) rose 6 cents per gallon from June 1997 to July 1997."

Cotterill and Franklin Response:

Well what is it, an assumption or a conclusion? It is neither. We maintain that it is an uncontested fact (see Cotterill and Franklin, 2001b, Section III). The Compact minimum price, which was the market price on 30 of the 40 periods after the Compact, was \$1.46 a gallon. This price is 6 cents higher than the average Class I price in the

before-Compact period (February 1996 to June 1997). This 6 cents per gallon increase averages 4.5 cents over the 40 weeks. Bailey in his own paper uses the exact same average farm price as part of his analysis (Bailey 2000, p. 22). Bailey's assertion in the last sentence of the paragraph is simply wrong. The 6 cents per gallon increase was not based on "an observation that the Class I farm price of milk rose 6 cents per gallon from June 1997 to July 1997. It is the difference between the average Class 1 price in the before Compact period (February 1996 to June 1997) and the Compact minimum.

Bailey:

"My own computation shows the Class I cost of milk to processors, which includes the announced minimum federal order price plus the cooperative premiums plus the Compact over-order obligation, averaged 12 cents per gallon over the period July 1997 through July 2000. Thus my figure conflicts with the authors' claim that only a 4.5 cents per gallon elevation in the retail milk price is justified."

Cotterill and Franklin Response:

As written, this is nonsense and shows that Bailey spent little time and care in drafting this review. Surely he does not mean that processors, on average, over the July 1997 through July 2000 period, paid 12 cents a gallon for milk. What he means to say is that if the Compact had not existed during that time period, the price farmers would have received would have been 12 cents lower than it actually was. As we explain in our accompanying paper this is a very different comparison. We examine how actual farm price changes from before the Compact to after the Compact. Bailey goes off in another dimension shows how the farm price after the Compact would change if there were no Compact. In other words, if the Compact premium was zero what would the farm price

during the after-Compact period be? Bailey fails to understand that these are distinctly different computations and there is no reason for them to be identical. In fact we would “never in a million years” expect them to be equal (see our accompanying paper, Section IV).

Bailey:

“Let’s get back to the authors Compact damages model. Essentially they used a retail price trend with a 6-cent per gallon increase in the retail milk price due to the Compact and a slight elevation for other marketing costs. He then compared this index to the actual retail milk prices. Thus, the authors never examined the actual farm-to-retail milk margin before and after the Compact implementation. They also fixated on just one period of the historical data: a comparison of the months prior to the Compact to July 1997. It is this comparison and the use of the index that I am strongly suggesting reflects an “unorthodox methodology.”

Cotterill and Franklin Response:

This is a confused and unintelligible explanation of our method. If this is the best that he can do, slight wonder he finds it “an unorthodox” method. Our approach is not that complicated. We compute an estimated “dollars per gallon” margin for before the Compact. Then we adjust it to allow for an estimated three percent growth rate in other costs during the after-Compact period. This is our “benchmark” margin, i.e. the margin that allows market channel firms to retain their before-Compact dollar net profits during the after-Compact period. Next, we tack this margin on to (add it to) the after-Compact farm price that processors paid and compare the resulting “no net profit change” retail price trend line to the actual observed retail price trend line. Since actual retail prices are

above the zero net profit change line, we find that firm's profits increase. This increase is net of increases in other costs and after paying higher prices for raw milk. This before-after method compares the economic positions of farmers, owners of the market channel firms, and consumers after the Compact to their position before the Compact.

If we use the average margin in the before-Compact period, as Bailey suggests, there is no change in the Compact impact and the market power components of the "damages" (his word) increases (see Cotterill and Franklin, 2001b, Table 2).

When computing impacts, we never "fixated on just one period of the historical data: a comparison of the months prior to the Compact to July 1997," as Bailey claims. We used all of the data and the impacts are reported for the flat farm price period, the farm price spike period, and the sum of these two periods (July 1997 through July 2000)

Bailey:

"Finally, the author's conclusion lacks a sense of logic that is necessary when reaching such strong conclusions. First, the authors only examined supermarket scanner data representing about 40 percent of the retail milk market. The other 60 percent was not studied. They conclude that the Compact raised \$128.5 million over the Compact period studied (July 1997-July 2000). That translates to \$51.5 million higher costs for processors on sales at the supermarket level ($0.40 * \$128.5$). Retail milk prices at the supermarket level rose \$130 million. However, of this amount, \$19 million was due to the Compact, \$49 million was due to market power, and the rest, \$61.6 million, was due to higher processing costs and Class I price spikes."

Cotterill and Franklin Response:

Bailey's first claim that we lack a "sense of logic" rests on the fact that we examine only supermarkets. But we clearly state this fact in our study and make no claims beyond the supermarket channel except for our analysis of the relation between all fluid milk sold and fluid milk sold through supermarkets (Figure II, Table F4 and related text). There is no lack of logic in our approach or our conclusions. Also, supermarket sales are 40 percent of all fluid milk sales (i.e., institutional and restaurant as well as retail). They are approximately 75 percent of retail food store sales. Bailey's restatement of our conclusions concerning dollar impacts is correct.

Bailey:

"If only \$19 million was passed on to consumers and processors paid \$51.5 million higher costs for milk due to the Compact, I would conclude that processors/retailers "ate" the difference of \$32.5 million. Given their study, I would argue that processors/retailers lacked the market power to pass these higher costs on to consumers. However, Cotterill and Franklin assumed just the opposite. Again, their numbers don't add up."

Cotterill and Franklin Response:

Bailey confuses before and after analysis with counterfactual analysis (See Cotterill and Franklin, 2001b, Section IV and VI). Consumers paid 19 million more for milk after as compared to before the Compact because of the Compact. After versus before the Compact, processors paid only 4.5 cents per gallon more (\$19 million more) for milk because of the Compact. Processors did not pay 51.5 million more (before versus after) for milk. If the Compact had not existed (counterfactual) then the processors during the after Compact period would have paid \$51.5 million less for milk

than they actually paid. Processors/retailers “ate” no increased milk costs. In fact we show that in addition to passing on to consumers the 4.5 cents per gallon increase in their cost of raw milk due to the Compact, they increased retail prices to cover increases in other costs and in addition widened their net profit margins substantially. As documented in our companion paper (Cotterill and Franklin, 2001b), our revised estimates are 2.7 cents per gallon or 11.4 million dollar Compact impact and 13 cents per gallon or 54.2 million dollar impact due to market power for all New England. The numbers add up when one analyzes what actually happened in the market place.

Bailey:

“To conclude, Cotterill and Franklin used an unorthodox methodology to reach unsubstantiated claims regarding the retail price impact of the Compact. Their methodology is simply not supported by the Agricultural Economics literature. In addition, their claims of market power and tacit price collusion are not supported by the data. One has only to ask whether a retail milk price of \$2.78 per gallon in the Northeast supports such claims. Logic will tell you it does not.”

Cotterill and Franklin Response:

We reject Bailey’s “unorthodox methodology” claim for the reasons given in this response and Cotterill and Franklin, 2001b. Our impact assessment method is straightforward, clear, and not in contravention to policy impact analysis, who gains, who loses, as done in agricultural economics, economics, or public policy studies. We readily admit that we do not use a farm-to-retail price transmission model. We do so because the data do not support that approach. Our claim of market power and tacit collusion most certainly are supported by the data and public documents. A large section of our report

presents brand and chain level price and quantity data and analysis that clearly document the exercise of market power. Figure 4 in the report documents that Garelick brand and private label retail milk prices rose more than Hood prices, closing the brand gap. Hood's price also rose. Figures 14 and 15 document that Garelick and private label quantity sold decreased when their prices increased. Estimated brand level demand elasticities indicate that retail price elevation of Garelick and private label prices, brands that are controlled by Suiza Foods and Stop & Shop at the processor level, was profitable. Market power was indeed exercised. According to our revised estimates, the all New England retail price of \$2.78 per gallon is 13 cents higher than it would be if market channel firms had not widened the margin beyond the amount needed to cover increases in non milk input costs (Cotterill and Franklin, 2001b, Table 3). Bailey's logic in rejecting our analysis remains a mystery because he never states it.

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All Cotterill et al. papers are available at <http://www.are.uconn.edu/fmktc.html>. Papers by Kenneth Bailey are available at <http://www.aers.psu.edu/Dairy/Outlook/reports/NECompactStudy.htm>.