

Federal Trade Commission

Office of the Regional Director

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**COMMISSION
APPROVED**

Michael J. Bragman, Chairman
N.Y.S. Assembly Committee on Agriculture
State Capitol Building
Albany, New York 12248

Dear Chairman Bragman:

The staff of the Federal Trade Commission is pleased to respond to your invitation to comment on Assembly Bill No. 3643 ("A. 3643"), a proposal to permit increased competition in milk distribution throughout New York State.¹ Milk distribution in New York State is currently subject to a licensing law, Section 258 of the Agriculture and Markets Law, that inevitably frustrates competition and injures consumers. A. 3643 would open New York's milk markets to increased competition. This, in turn, would result in greater efficiency in milk processing and distribution and lower prices to consumers. Accordingly, we strongly urge its passage.

The Federal Trade Commission (the "Commission") is an agency charged by Congress with preserving competition in the marketplace and protecting consumers from deceptive and unfair business practices.² In furtherance of this mandate, the Commission frequently appears before other regulatory agencies,

¹ This letter presents the comments of the New York Regional Office and the Bureaus of Competition, Economics, and Consumer Protection of the Federal Trade Commission. The views expressed are not necessarily those of the Commission or of any individual Commissioner, although the Commission has authorized the presentation of these comments.

² The Commission enforces Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45 (1982), which proscribes "unfair methods of competition" and "unfair or deceptive acts or practices." The Commission also undertakes economic studies at the request of Congress and the Executive branch. 15 U.S.C. § 46(f) (1982).

legislatures, and the courts to help assess the consumer benefits that result from free and open competition.³ We hope that our comments will assist the Assembly in its present deliberations.

I. THE CURRENT LAW

Section 258-c of the Agriculture and Markets Law permits the Commissioner of Agriculture and Markets (the "Commissioner") to deny a license to distribute milk in New York if he finds that entry by an applicant will "tend to a destructive competition in a market already adequately served" or is "not in the public interest."⁴ Section 258-c also permits the Commissioner to deny, revoke, or suspend a license to distribute milk because the applicant or dealer has committed an act "in demoralization of the price structure" of milk. In addition, Sections 258-r and 258-u of the Agriculture and Markets Law

³ The Federal Trade Commission, its Chairman, and its staff have addressed New York State's milk licensing regulations on previous occasions. Most recently, by letter of October 28, 1986, Federal Trade Commission Chairman Daniel Oliver urged Governor Cuomo to support repeal or in its absence adoption of a less restrictive interpretation of the statute. Earlier, on November 1, 1985, David Scheffman, then Acting Director of the Bureau of Economics, wrote to Chairman Richard J. Keane of the Assembly Agriculture Committee recommending repeal of New York's statutory restrictions on entry into milk marketing. Prior to that, by letter of February 27, 1984, the full Commission urged the Department of Agriculture and Markets Commissioner Joseph Gerace to adopt a pro-competitive interpretation of the statute in his consideration of the license application of Tuscan Dairy Farms, Inc.

⁴ Section 258-c of the Agriculture and Markets Law (McKinney Supp. 1986) provides that "[n]o license shall be denied to a person not now engaged in business as a milk dealer . . . unless the commissioner finds by a preponderance of the evidence . . . that the issuance of the license will tend to a destructive competition in a market already adequately served; or . . . is not in the public interest."

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regulate the advertising and sale of milk "below cost."⁵ Nowhere in the statute, however, are the terms "destructive competition," "already adequately served," "in the public interest," "demoralization," or "below cost" defined. Thus, while the statute purports to provide standards for the Commissioner to use in determining whether to grant a license to a potential entrant, it really vests almost total discretion in the Commissioner. As a result, the Commissioner has wide latitude to apply the statute in such a way as to exclude competitors and protect the pecuniary interests of firms already in the market, all at the expense of the public.

Indeed, application of New York's milk distribution regulations was recently held unconstitutional by Judge Wexler of the U.S. District Court. In overturning the denial of Farmland Dairies'⁶ application to distribute milk in New York City, Judge Wexler found that the Commissioner's denial was pure economic protectionism of in-market firms and that it placed an unconstitutional burden on interstate commerce. While Judge Wexler's decision invalidated Section 258-c only as applied by the Commissioner, his analysis appears to make a constitutional

⁵ Section 258-r of the New York Agriculture and Markets Law (McKinney 1972) provides that a dealer may not advertise or sell milk at a price below the dealer's cost unless the dealer notes in advertisements and at the point of sale that the milk is being sold below cost. Section 258-u of the Agriculture and Markets Law (McKinney Supp. 1986) provides that it is unlawful to purchase or sell milk "at prices below cost where the purpose or effect of such transaction is to destroy competition or eliminate a competitor."

⁶ Farmland Dairies is Fair Lawn Dairies' parent corporation. For ease of reference, throughout this letter both will be referred to as "Farmland Dairies."

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application of Section 258-c extremely difficult, if not impossible.⁷

Moreover, the license application process itself increases entry costs and serves as a deterrent for potential competitors. Firms already in the market are afforded an opportunity in the license application hearings conducted by the Department of Agriculture and Markets to delay entry of competitors in order to preserve their positions in the market.⁸ For example, when Farmland Dairies applied for a license to serve Nassau and Suffolk Counties, its request remained pending in various forums for seven years. Indeed, its application might not yet have been decided but for the settlement agreement resulting from Judge Wexler's decision.⁹ Other viable potential entrants less able to pursue an application with such vigor might choose to forego entry rather than subject themselves to the substantial expense and uncertainty of this regulatory system.¹⁰

⁷ Indeed, Judge Wexler stated that "a decision by this Court striking down § 258-c would not be without foundation;" however, he found that considerations of state/federal comity counseled against determining the constitutionality of the statute as written. Farmland Dairies v. Gerace, No. CV 86-1933, slip op. at n.4 (E.D.N.Y. Jan. 8, 1987). See also id. at 7, 9-10, and 17-18. After Judge Wexler's decision, the State entered into a settlement with Farmland granting the dairy the sought-after licenses to sell milk in New York City and Nassau and Suffolk Counties.

⁸ The Legislative Commission on Expenditure and Review, in April 1985 Audit, State Milk Dealer Licensure and Regulation, noted that "competing milk dealers almost always oppose granting [a] license."

⁹ Discussion of the administrative delay to which applicants for New York State milk licenses are subjected is contained in U.S. Department of Agriculture, State Milk Regulation: Extent, Economic Effects, and Legal Status 5 (USDA Econ. Research Service, Apr. 1986).

¹⁰ Cf. Salop & Scheffman, Raising Rivals' Costs, 73 Am. Econ. Rev. 267 (1983).

By permitting the exclusion of competitors, the current licensing scheme insulates existing licensees from the spur of competition. In so doing, it suppresses innovation, encourages the adoption of wasteful, cost-inflating practices, and misallocates resources.¹¹

It is New York's consumers who have ultimately borne the brunt of the current restrictive licensing provisions. The injury to consumers finds its most dramatic expression in the vast overcharges they pay for milk.

The New York Public Interest Research Group, Inc. ("NYPIRG") released a study on May 8, 1985, that found New York City consumers paid \$.36 more per gallon on average than consumers in nearby northern New Jersey. Relying upon a study conducted by the Department of Agricultural Economics at Cornell University, NYPIRG calculated that only \$.02 to \$.06 of the per gallon price difference was attributable to the higher cost of retailing in New York City. The remaining \$.30 to \$.34 per gallon "are a direct result of a monopolistic milk distribution industry that is being perpetuated by the State of New York."¹² Thus, in New York City alone, the cost to consumers of excluding efficient competitors from the milk market under the supposed

¹¹ See Manchester, Milk Pricing, Econ. Res. Serv., U.S. Dept. of Agric., Agric. Econ. Rpt. No. 315 at 12 (Nov. 1975):

[a]nother effect of resale price regulation, whether done directly by price setting or more circuitously through trade practice regulation, is to maintain the status quo. Since any change represents a potential competitive threat to someone, there usually is resistance to change. Often the rate of innovation -- whether new containers, new services, new products, or changes in the price structure -- tends to be slower in areas with such regulation than elsewhere.

See also Kahn, The Theory and Application of Regulation, 55 Antitrust L.J. 177, 178 (1986); Flexner, Braden, Clinton, Collins, Forrest & Gorinson, Report on Regulatory Reform by the Industry Regulation Committee, Section of Antitrust Law, 54 Antitrust L.J. 503, 512-13 (1985).

¹² Letter of June 3, 1985, from Paul Herrick, NYPIRG Assistant Legislative Director, to New York State Assembly Agriculture Committee members.

protection of Section 258-c may have exceeded fifty-six million dollars in each of the last several years.¹³

NYPIRG's analysis is supported by a recent survey conducted by New York Attorney General Robert Abrams. The Attorney General found that milk prices in Staten Island dropped approximately 10% following the entry of Farmland Dairies into that market. For instance, milk prices in small Staten Island groceries and dairies declined from \$2.51 to \$2.22 a gallon; and in Staten Island supermarkets prices declined from \$2.34 to \$2.22 a gallon.¹⁴

More recently, after Judge Wexler overturned the denial of Farmland's application to distribute milk in New York City, Farmland Dairies began selling milk in all of New York City and in Nassau and Suffolk Counties. Press reports indicate that milk prices to consumers at numerous outlets in those areas already have fallen by \$.18 to \$.71 per gallon.¹⁵

The overcharges that consumers have paid over the last several years may reflect the protection afforded by the current law to inefficient firms in the market; they also may reflect above-normal profits that result from tacit or express price fixing or customer allocations among in-market firms -- conduct facilitated by the exclusion, under Section 258-c, of potential competitors. For example, the five largest processors in New York City (who account for over 80% of milk sales in that market) have been recidivist antitrust violators. In 1956, 1966,

¹³ This estimate is derived by multiplying annual milk consumption in New York City, roughly 178,044,060 gallons per year according to the June 1986 Fluid Milk Reports published by the New York State Department of Agriculture and Markets, by the average per gallon overcharge noted in the NYPIRG study discussed above: $178,044,060 \times \$0.32 = \$56,974,099$.

¹⁴ "Abrams Finds Lower Milk Prices In Staten Island; Urges Legislature To Deregulate Milk Licensing," News From Attorney General Robert Abrams (Mar. 2, 1986).

¹⁵ New York Times, Jan. 17, 1987, at 29, col. 2. See also New York Daily News, Jan. 17, 1987, at 3, col. 1, and The Wall Street Journal, Jan. 15, 1987, at 22, col. 1.

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and again in 1982, these five processors were found to have conspiratorially fixed prices and allocated markets.¹⁶ Additionally, the record in the recently concluded Farmland Dairies hearing is replete with evidence that once the ordinary milk retailer selects its first supplier, he becomes the property of that supplier.¹⁷ In all these cases, it is New York's consumers who have borne the burden of the resulting higher milk prices.

II. JUSTIFICATIONS FOR THE CURRENT LAW ARE UNPERSUASIVE

The proponents of present Section 258-c argue that entry into a milk market may result in intense price competition, or as some say "destructive competition." As a result, the proponents argue, weaker dealers may abandon routes or be driven from the market, leaving some accounts underserved or over-charged.

If, however, milk dealers are driven from the market by new competition, it is because their costs are higher than those of the new entrants,¹⁸ and indeed are too high to enable them to survive in the more competitive environment. If high-cost sellers exit the market, consumers are not harmed. Rather, the

¹⁶ People v. Milk Handlers & Processors Ass'n, Civ. No. 40077/57 (N.Y. Sup. Ct. Aug. 13, 1958); State v. Milk Handlers & Processors Ass'n, Civ. No. 41396/1966 (N.Y. Sup. Ct. Sept. 11, 1975); and People v. Elmhurst Milk and Cream Co., Inc., 116 Misc. 2d 140, 455 N.Y.S.2d 473 (Sup. Ct. Kings Co. 1982); People v. Dairylea Coop. Inc., 114 Misc. 2d 421, 452 N.Y.S.2d 282 (Sup. Ct. Bronx Co. 1982); People v. Queensboro Farm Products, Inc., 1982-83 Trade Cas. (CCH) ¶65,071 (Sup. Ct. Queens Co. 1982); State of New York v. Dairylea Coop. Inc., 81 Civ. 1891 (S.D.N.Y. 1982).

¹⁷ In the Matter of the Application of Fair Lawn Dairies, Inc. For an Extension of Its Milk Dealer's License, Before Lyle Newcomb, Hearing Officer, June 23, 1986 ("Transcript") at 1454-59, 1873-77, 1920-29, 1943, 1955, 1969-70, and 1985-86.

¹⁸ Vigorous competition "driv[es] out surplus and inefficient production capacity and compel[s] the reallocation of resources into more remunerative lines." F. Scherer, Industrial Market Structure & Economic Performance 213 (2d ed. 1980). See also International Tel. & Tel. Corp., 104 F.T.C. 280, 402-03, 425 (1984).

presence of low-cost firms benefits consumers by affording them the opportunity to purchase milk at a lower price.

Similarly, there is no reason to believe that if a current competitor exits the market, there will be a "void" in the distribution system (*i.e.*, smaller retailers will be left without service). Rather, any unserved accounts can be expected to be served both by competitors in the market¹⁹ and -- absent government restrictions -- by new entrants who will seek to expand into any profit opportunity resulting from another firm's withdrawal from the market.²⁰

Likewise, the justification for the statutory prohibition against sales below cost is unpersuasive. Below cost pricing that is injurious to consumers is generally known as "predatory pricing." This term usually refers to sustained sales below cost with the intent of driving competitors from the market, and under circumstances, namely where there are high entry barriers, that would thereafter permit the predator to raise and sustain prices at supracompetitive levels.²¹ It is unlikely, however, that New York State milk markets will be subject to predatory pricing. As previously discussed, absent government restrictions on entry, potential competitors stand ready to enter and compete in New York's milk markets. Thus, the presence of these potential competitors should restrain a predator's ability to raise price above competitive levels in order to recoup its earlier losses on "below cost" sales.

Additionally, the mere existence of the prohibitions on "below cost pricing" may well have a chilling effect on vigorous

¹⁹ For example, in the Farmland Dairies hearing in-market firms testified that they would be more than happy to serve any customer abandoned by another. See, e.g., Transcript at 341 and 771.

²⁰ For example, Farmland Dairies stated during its license extension hearing that it planned to service the milk requirements of outlets of all descriptions if the requested license were granted. Transcript at 1524. Moreover, in addition to other New Jersey (and, of course, New York) dairies, the present-day pool of potential marketers of milk in New York State extends into Connecticut and even the non-contiguous New England states. See N.Y. Agric. & Mkts. Law § 258-p (McKinney 1972).

²¹ See Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 106 S. Ct. 1348, 1357-58 (1986).

price competition.²² Scholars and jurists have devoted great attention to the distinction between a predatory and competitive price,²³ a distinction not easily made. The greater danger under the present statute is not that the Commissioner may overlook an instance of predatory pricing, but rather that he may wrongly prohibit vigorous price competition. Moreover, fearing such action by the Commissioner, milk dealers may refrain from active price competition. In either event, the public would be harmed, without a real countervailing benefit.

Finally, prohibitions on sales below cost contained in the present milk licensing regulations are not necessary to redress below cost pricing conduct that is predatory. Both state and federal antitrust laws already have prohibitions against such activity and could be used to address any such conduct in the marketplace.

III. ASSEMBLY BILL No. 3643

Assembly Bill No. 3643 addresses the major infirmities of the present scheme. A. 3643 would ease entry into New York State milk markets by establishing state-wide licensure²⁴ and by eliminating the "destructive competition" standard and the similarly broad "public interest" standard from the State's licensing system.²⁵ A. 3643 also would repeal the portion of Section 258-c that permits the Commissioner to deny, revoke, or suspend a license to distribute milk because the applicant or

²² Similarly, the statute's requirement that dealers accompany any below cost pricing with advertising and point-of-sale disclosures may subject discounters to potential retaliation from other industry members. As a result, this may limit the vigor of retail price competition.

²³ See, e.g., Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 106 S. Ct. 1348, 1360 (1986); International Tel. & Tel. Corp., 104 F.T.C. 280, 415 (1985); Scherer, supra note 18, at 212-15; and Areeda & Turner, Predatory Pricing and Related Practices Under Section 2 of the Sherman Act, 88 Harv. L. Rev. 697 (1975).

²⁴ A. 3643 §§ 3 and 5. While we believe licensing schemes ought to be scrutinized carefully to ensure that the costs to competition and consumers do not outweigh any intended benefits, we recognize that New York has a legitimate interest in protecting the health and safety of its milk consumers.

²⁵ A. 3643 § 9.

dealer has committed an act that tends to demoralize the price structure of milk.²⁶ In addition, A. 3643 would repeal the provisions of the current law, discussed in note 5 supra, that regulate the advertising of milk offered for sale "at a price which is lower than the price paid by the dealer for such milk"²⁷ Taken together, these provisions will go a long way toward restoring the benefits of competition to consumers. Indeed, as retail milk prices go down, the quantity of milk demanded by consumers will tend to increase. Thus, passage of A. 3643 should result in expanded opportunity for efficient marketers of raw and finished milk and widespread availability to consumers of milk at dramatically reduced prices. We see no credible countervailing considerations.

There is, however, one provision of A. 3643 that in our view continues to limit competition. Section 15 of A. 3643, like Section 258-u of the current law, proscribes below cost pricing. In the new law, however, below cost pricing is defined as pricing below average variable cost. The inclusion of a definition of this term is an improvement over the current law, which contains no statutory definition. However, the retention of the statutory proscription of below cost pricing, even if defined, has the potential to stifle honest competition. For example, this provision might prohibit a new entrant from engaging in "loss leader" pricing, in which brief episodes of below cost pricing are used to develop goodwill and, ultimately, increase patronage in general. Such an investment in goodwill is an effective and honestly competitive tactic of particular importance to firms seeking to break into a market.²⁸ And, of course, loss leader pricing presents consumers with the immediate boon of lower prices on select purchases.

As we noted previously, below cost pricing that is predatory already is adequately proscribed by state and federal antitrust laws. To the extent that Section 15 of A. 3643 would continue to bar predatory pricing, it is redundant; to the extent that it threatens to punish non-predatory pricing, it is harmful

26 A. 3643 § 10.

27 N.Y. Agric. & Mkts. Law § 258-r(2) (McKinney 1972).

28 See General Foods Corp., 103 F.T.C. 204, 344 (1984).

to producers and consumers alike. In order to optimize consumer well-being the Assembly may wish to repeal, rather than merely revise, the current Section 258-u.

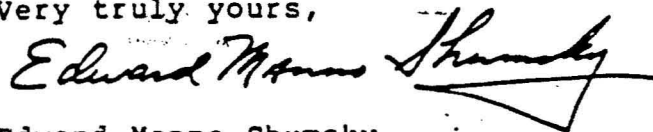
Finally, apparently "to safeguard dairy farmers against losses resulting from defaults in payments for milk," A. 3643 would impose more restrictive payment, surety, and other conditions upon milk dealers.²⁹ We are not in a position to determine the need for such conditions. We note, however, that such requirements impose costs on would-be milk dealers that may discourage entry. Therefore, some of the competitive thrust of A. 3643 may be forfeited. These regulatory costs should be considered in assessing whether the adoption of more restrictive conditions, on balance, serves the public interest.

IV. CONCLUSION

We share the interest of New York State in assuring the availability of affordable wholesome milk to its citizens. We are concerned, however, that the current milk licensing law does not serve that interest. By limiting competition in the distribution of milk, these regulations restrict commercial opportunities and burden milk consumers with vast overcharges. In our view, A. 3643 will restore competition to New York's milk market to the benefit of all consumers. With the caveat discussed above, that Section 258-u (regarding below cost pricing) be repealed rather than merely revised, we strongly urge passage of A. 3643.

We hope these comments assist the Assembly in its deliberations. Please do not hesitate to contact us if you have any questions or would like further information.

Very truly yours,



Edward Manno Shumsky
Regional Director

²⁹ For instance, A. 3643 § 8(c) requires milk dealers to file a mandatory minimum surety bond in an amount equal to the sum of the value of milk purchased for two consecutive months and the amount owed for the same two months to the equalization or producer settlement fund.